

# **FIELD AUDIT PROCEDURES MANUAL**

## **DISCLAIMER:**

**The information in the Massachusetts Department of Revenue’s Field Audit Procedures Manual is provided for the guidance of audit staff. However, the Audit Division reserves the right to depart from the standard processes outlined herein when and as it deems such departure to be warranted under the circumstances. Any such departure will be done with the approval of the Audit supervisor and or manager and in no way undermines or invalidates any audit finding so long as all statutory requirements are met. The Field Audit Procedures Manual does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated. The Field Audit Procedures Manual and the information contained therein may neither be cited to support an audit position nor may it be relied upon by a taxpayer. Furthermore, the Field Audit Procedures Manual does not constitute a public policy statement or “other written guidance issued by the commissioner” as described in or for purposes of chapter 62C, section 26(j).**

# Field Audit Procedures Manual

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# Chapter 1

## Introduction

### Overview

This manual is intended to provide field auditors with an understanding of their accountabilities and responsibilities in the conduct of audit assignments. The primary focus is on auditing standards and procedures established by the Audit Division to ensure professionalism and integrity in audit operations.

The Field Audit Procedures Manual is to be utilized in conjunction with the Division's Audit WorkBench (AWB) or Electronic Audit Case Folder, the Discover Tax Warehouse (DTAX) and the Department's computerized MASSTAX Declaration System (MASSTAX).

Auditors are expected to be familiar with all internal forms, definitions and procedures described in the Audit WorkBench (AWB) Manual and the MASSTAX Phase II Declaration System Manual.

This manual is the property of the Massachusetts Department of Revenue. It must be turned in to your immediate supervisor upon leaving the Audit Division or the Department.

### Mission Statement

The Audit Division maintains a strategy that assures the citizens of the Commonwealth that our system of taxation, relying on voluntary compliance, will remain effective and efficient.

### Audit Elements

An auditor's primary function is to determine if a tax has been correctly reported. Audits should be completed in a professional and efficient manner and should create the least possible inconvenience for taxpayers.

Five essential elements are used to meet audit objectives:

**Taxpayer Relationships.** The benefit derived from developing a good relationship with a taxpayer is two-fold. The taxpayer tends to become more comfortable with the audit situation, which allows the audit process to flow more smoothly, and the auditor is able to secure taxpayer cooperation, which enables timely completion of the audit.

**Planning Activities.** Planning an audit begins when an audit assignment is received. It is very important that all audit activities, including pre-audit preparation, be documented in the Audit WorkBench (AWB)-Case Log and Case Plan (See Chapter 3, Audit

Planning and Documentation-The Electronic Audit Case Folder).

**Examination of Records.** Gathering and evaluating sufficient records is essential for providing an adequate basis for determining the accuracy of the tax returns filed. The auditor should always discuss and review with the taxpayer what records may be available in electronic format. The use of auditing tools such as DOR's Computer Assisted Auditing Techniques (CAATS) is encouraged in an effort to streamline the audit process. While the use of a full scale CAATS audit may not be possible, the auditor should consider how the use of any available electronic records might enhance the ability to complete the audit in the most efficient manner (See Specific Chapter for Audit Procedures by Tax Type).

**Application of Law.** An auditor must be knowledgeable with the requirements of the law administered. Copies of all tax laws and the MASSTAX Legal Guide, which provides DOR written pronouncements and regulations, are available to every auditor and updated annually. The Legal Library is also available on DORNET.

**Documentation.** Documentation is used to compile pertinent facts discovered during an audit. A well-documented audit will consist of a complete record of evidence examined by the auditor to support any findings on the audit work papers included in the electronic audit case folder through Audit WorkBench (AWB)-Attachments. Also, document any oral statements made by the taxpayer that may be important to support any audit findings through the Audit WorkBench (AWB)-Case Log (See Chapter 3, Audit Planning and Documentation-The Electronic Audit Case Folder).

## **Audit Process**

**Audit Assignment.** The first step in the audit process occurs when the auditor receives the audit assignment through My-Inventory in Audit WorkBench (AWB). The source of audit assignment and audit period selected must be documented in the Audit WorkBench-Case Log and audit narrative along with indicating this step on the Audit WorkBench-Case Plan (See Chapter 2, Pre-Audit Research).

**Pre-Audit Research and Review.** This research period is the step in which the auditor reviews information about the taxpayer and/or the business to be audited. Information can be obtained from DTAX, MASSTAX, reviewing prior audit folders; if available, and the Internet (See Chapter 2, Pre-Audit Research).

**Taxpayer Contact.** The first contact with the taxpayer occurs after the initial pre-audit research and review has been completed. The auditor calls or writes the taxpayer to arrange an appointment to begin the audit. A pre-populated Notice of Audit Appointment and Checklist/Information Document Request are created through Audit WorkBench (AWB)-Notice Generation (See Chapter 2, Pre-Audit Research).

Note: All contact information, especially Power-Of-Attorney information, can be entered into Audit WorkBench-Contacts which will transfer the contact information to the recipient data field in Notice Generation. This creates a copy of a particular notice for the taxpayer as well as the recipients, i.e. POA.

**Opening Conference.** The first face-to-face meeting with the taxpayer occurs during the opening conference. The auditor will outline the audit process for the taxpayer, obtain more information regarding the taxpayer's business, answer taxpayer questions, discuss records required including the availability of electronic records and ask any other questions that will help in completing the audit (See Chapter 4, Opening Conference).

**Examination of Taxpayer Records.** It is important to determine how the taxpayer calculated the reported amounts. The auditor should have the taxpayer explain how the return was prepared. The auditor should reconcile appropriate accounts with the taxpayer's filing history after establishing the validity of summary records. Work papers, documents received from Taxpayers, all correspondence, and any other pertinent documents should be included in the electronic audit case folder in Audit WorkBench (AWB)-Attachments (See Specific Chapter for Audit Procedures by Tax Type).

**Exit Conference.** Upon completion of the field work, the taxpayer is given the opportunity to meet with the auditor's supervisor or manager and discuss the results of the audit and administrative remedies including Administrative Procedures (AP) 633-the Guidelines for the Waiver and Abatement of Penalties and Pre-Assessment conference and/or settlement requests (See Chapter 5, Audit Completion-Documentation of Audit Findings & Administrative Remedies).

**Audit Completion.** This step entails the process of summarizing the results of the examination. The auditor prepares the electronic audit case folder for review by attaching the above mentioned work papers, and the audit narrative. In cases where a Notice of Intention to Assess (NIA) will be issued, final assessment summary and assessment interface details are needed to transition the case from Audit WorkBench (AWB) to AAHT in MASSTAX. Assessment interface is not required for cases where returns are secured (See Chapter 5, Audit Completion-Documentation of Findings & Administrative Remedies).

**Audit Review.** When the audit write-up is completed, it will be reviewed through Audit WorkBench (AWB) by the supervisor or designated approver in the hierarchy based on dollar delegation. The purpose of the review is to ensure that the audit is technically, procedurally and mathematically correct. Once the case is approved, the case will be validated and interfaced through Audit WorkBench (AWB) resulting in the issuance of the NIA which is sent to the taxpayer (See Chapter 5, Audit Completion-Documentation of Findings & Administrative Remedies).

**Contested Audits.** If the taxpayer disagrees with the audit findings, the taxpayer and/or taxpayer's representative may request a conference in accordance with MGL, Chapter 62C, section 26(b). The conference conducted with the Office of Appeals (OOA) gives the taxpayer the option of a pre-assessment conference and/or settlement consideration. The electronic audit case folder will be forwarded to the Office of Appeals (OOA) through Audit WorkBench (AWB) for the appropriate action necessary (See Chapter 5, Audit Completion-Documentation of Findings & Administrative Remedies).

### **Statute of Limitations for Assessment**

Massachusetts has established a uniform three-year statute of limitations on all taxes. The statute expiration date is generally three years from the statutory due date of the return or the date the return was filed, whichever is later. In the case of a false or fraudulent return or failure to file a return after notice is given, an assessment can be made at any time in accordance with G.L. c.62C, section 26 (d) and section 28. In the case of an underreporting of gross income by 25% or more on income returns or underreporting of transactional tax (including excise tax of banks, public utilities and insurance companies) by 25% or more, an assessment can be made within six years in accordance with G.L. Chapter 62C, section(s) 26 (h) and (i).

In determining the expiration date for assessment on any return filed after the statutory due date, auditors must verify and confirm the actual date of filing. The imposition of late file penalties is proposed for any return filed after the statutory due date and lacking the Commissioner's granting of an extension of time for filing said return.

### **Non-Filer Enforcement Criteria**

**General Rule - Seven-Year Look-Back Policy.** When a taxpayer fails to file a required tax return, the Commissioner may make an assessment of tax at any time, without giving notice of his intention to assess for any taxable period for which a return was due. See, G.L. Chapter 62C, section 26(d). The statute does not limit the number of past due returns the Commissioner may assess. However, in any instance involving a failure to file, the Commissioner generally seeks to balance considerations of taxpayer compliance and appropriate agency resource allocation. In keeping with these general considerations, the Commissioner established policies regarding taxpayers that have failed to file returns due for past taxable periods: a seven-year look-back policy for all non-filer resident taxpayers and non-resident taxpayers that the Department discovers have failed to file returns, a three-year look-back policy for non-resident taxpayers and foreign corporations or other foreign entities that voluntarily disclose past due filing obligations, and a separate look-back period (4-7 years) for individual use tax obligations (See TIR 03-17).

When the Commissioner determines that a taxpayer has failed to file tax returns which were required, the Commissioner may assess the taxpayer with respect to returns due during the most recent seven years. The seven-year (i.e., eighty-four month) look-back period will commence with the final day of the most recent taxable period for which the

taxpayer was required to file a return for the tax type in question. The look-back period shall be determined (without regard to extensions) as of the date the Commissioner first contacted the taxpayer in writing concerning such tax. If an individual taxpayer or corporation voluntarily files some or all of its overdue returns without first being contacted by the Commissioner, the look-back period will be determined as of the date the taxpayer filed one or more returns with the Commissioner.

When a taxpayer was previously required to file returns but is no longer so required, the Commissioner will assess the taxpayer for the final seven years (i.e., eighty-four months) for which the taxpayer was required to file returns, provided that the Commissioner did not contact the taxpayer concerning such returns before the due date for its final return. The above policy does not affect assessments which the Commissioner might otherwise lawfully make (e.g., as to returns which are subsequently required, insufficient returns and the failure to pay a required tax). Non-resident individual taxpayers, foreign corporations and other entities that voluntarily disclose a past due filing obligation may qualify for the three-year look-back policy.

**Factors Supporting Assessment of Additional or Fewer Taxable Periods.** In certain instances the Commissioner, notwithstanding the policies stated above, may require additional returns to be filed, up to and including all past due returns. Likewise, in certain circumstances the Commissioner, notwithstanding the policies stated above, may require fewer than seven years of past due returns. In both cases, the Commissioner will consider pertinent facts and circumstances, including:

1. the degree of flagrancy and history of the taxpayer's noncompliance;
2. the existence of income from illegal sources;
3. special circumstances peculiar to the specific taxpayer, or peculiar to the taxpayer's business or industry;
4. the cost to the Commissioner to secure the tax revenue through means other than voluntary disclosure;
5. whether there was a basis for any reasonable doubt on the part of the taxpayer as to its filing obligation;
6. failure to file returns and remit withholding tax pursuant to Chapter 62B, section 2;
7. failure to file returns and remit trustee type taxes collected but not paid over (such as sales tax, meals tax or room occupancy tax);
8. an attempt in any manner to evade or defeat any tax, or a willful failure to collect, account for and pay over trustee taxes (including instances punishable pursuant to Chapter 62C, section(s) 73 (a) and (b));
9. willful neglect to file returns despite reasonable cause to know of a filing responsibility; and
10. sporadic filings not justified by objective circumstances.

A framework of the assessment provisions under G.L., Chapter 62C authorizing the Commissioner to assess a tax and the notice requirements with time frames in which an assessment is to be made is shown below.

**Statutory Authority for Assessment**

<b>[1] ASSESSMENT CRITERIA</b>	<b>MGL, Ch.62c STATUTORY AUTHORITY FOR ASSESSMENT</b>	<b>NOTICE OF INTENTION TO ASSESS REQUIREMENTS</b>	<b>ASSESSMENT TIME FRAME</b>
Verification of return determines proper tax not reported.	26(b)	NIA required	Within 3 years after the return was filed or the statutory due date, whichever is later.
Filed returns/mathematical or clerical error.	26(c)	NIA not required by law.	Audit policy is to issue NIA Within 3 years after the date the return was filed or the statutory due date, whichever is later.
Failure to file return after Commissioner notification. (NFF).	28	NIA not required by law. Audit policy is to issue NIA only in those cases where the filing requirements of a foreign corporation or non-resident are in dispute.	Anytime
False or fraudulent return filed with intent to evade a tax or failure to file a return.	26(d)	NIA not required by law.	Anytime
Filed returns/understatement	26(h)	NIA required	Within 6 years after the date

of gross income by 25% or more			the return was filed or the statutory due date, whichever is later.
Filed returns/understatement of tax by 25% or more.	26(i)	NIA required.	Within 6 years after the date the return was filed or the statutory due date, whichever is later.
Tax in jeopardy	29	NIA not required by law.	Immediately, whether or not the time otherwise prescribed by law for filing the return and paying tax has expired.
Determination of a filing of an incorrect or insufficient return after Commissioner notification (NIR).	28	NIA not required by law.	Audit policy is to issue NIA. Within 3 years after the date the return was filed or the statutory due date, whichever is later.
Filing of a false or fraudulent return with a willful intention to evade tax.	28	NIA not required by law.	Anytime

## Extending the Time for Assessment of Taxes (Waivers)

### Introduction

Statute control is critical to the successful operation of every group within the Audit Division. The Commissioner has three years from the date a return is filed or the date

the return was required to filed, to assess additional taxes (See G.L. Chapter 62C, section 26(b)).

Accordingly, it is incumbent upon all employees to know their role and responsibilities regarding statute protection and the handling of consent waivers, so that the Commonwealth's interest can be protected.

If, before the expiration of the time prescribed for the assessment of any tax, the Commissioner and the taxpayer consent in writing to extend the time for the assessment of the tax, the Commissioner or his duly authorized representative may examine the books, papers, records and other data of the taxpayer, may give any notice required and may assess the tax at any time prior to the expiration of the extended time.

The period so extended by the Commissioner and the taxpayer may be further extended through the use of consent waivers which are subsequent agreements in writing made before the expiration of time last extended. The waiver is a document signed by a person with legal authority to waive the statutory time requirement during which a notice of assessment must be issued by the Department. If, as a result of such examination, the Commissioner determines that the taxpayer has overpaid any tax, he shall reduce the assessment accordingly and refund the overpayment. (See G.L. Chapter 62C, section 27).

Consent to Extending the Time for Assessment of Taxes (Form A-37) also known as the waiver is signed by the case supervisor or manager and the authorized taxpayer representative and constitutes a legal document which should be date stamped when received. It establishes a new expiration date for specific reporting periods to allow for the completion of an audit.

Note: In circumstances where the absence of a supervisor, manager or director would compromise the statute of limitations, the auditor should sign and date the agreement. The auditor is allowed to execute a waiver by the DOR's Delegation of Authority.

Note: Waivers faxed, photocopied and received electronically through secure mail are acceptable. However, securing the original waiver is preferred.

**All Waivers Must Be Scanned and Attached in the Electronic Audit Case Folder.**

## **Detailed Procedures for Protecting the Statute of Limitations (SOL) General**

### **Information**

- The Consent Extending the Time for Assessment of Taxes can be retrieved from Audit WorkBench- Notice Generation.
- The form (1) should be returned with original signature(s).
- Upon execution, the auditor will submit Form A-37 (waiver) to the supervisor/manager for approval and the supervisor/manager or their designee will make the appropriate SOL update in Audit WorkBench-Period Details:

Statute of Limitations. The form (1) will be scanned and attached to the electronic audit case folder then sent to the taxpayer.

- All data in Audit WorkBench pertaining to statute control must be verified by someone other than the person actually entering the information to the system. Management must approve all SOL changes before edits can be made by the designee.
- Any subsequent changes to an executed agreement must be effected by the execution of a new agreement.
- This agreement must be executed at least 31 days before the original statute expiration date of the period(s), or before the extended expiration date(s) on the previously executed agreement(s), if an NIA has not already been issued. This is to ensure that a timely assessment can be made pursuant to Massachusetts General Laws, Chapter 62C, section 26(b).
- Upon assignment or at any time during the course of the audit, the auditors are responsible for securing taxpayer agreement to an extension of time for all report periods in which there is less than 90 days to the date of expiration for assessment.

Note: Only in unusual circumstances should the statute of limitations be allowed to go below 90 days.

### **Initial SOL Determination**

The DTAX Warehouse is the key database that houses information that is processed through MASSTAX including return file dates which dictates the statute of limitations for returns within audit periods. However, checks and balances are essential to ensure that all information entered into Audit WorkBench is correct. The effective dates of all filed returns in Audit WorkBench should be verified against the data in MASSTAX.

The following procedures are to ensure that safeguards are present during all phases of statute protection.

Unassigned Inventory - "Unassigned inventory" will constitute inventory that has not been assigned to an auditor through Audit WorkBench by his/her supervisor and does not have an established SOL or earliest date for expiration.

### **Assigned Inventory**

- Once a case is assigned, inventory and statute control become the joint responsibility of the supervisor and the case auditor. However, the auditor bears the primary responsibility for monitoring and protecting the SOL on all cases in his/her possession.
- To determine and protect the audit period(s) for transactional cases, the case supervisor or designee will associate the periods to the case through Audit WorkBench-Period Details: Create Periods or Manage Periods and will enter the

SOL date after reviewing the expiration date chart which displays the first and last day of the audit period based on the current period due which is supplied to each auditor at the beginning of the each calendar year.

- Once the periods are associated, return to the Period Details screen and review the effective date of the filed returns to establish the SOL.
- Once the SOL is established, enter the SOL in Audit WorkBench-Period Details: Statute of Limitations. The auditor/supervisor should select realistic first audit periods and expiration dates for cases. Exact expiration dates should be determined from your review of the applicable MASSTAX screens, Discover Tax Warehouse and examination of documentary evidence, i.e., tax returns, canceled checks.
- To determine and protect the audit period(s) for income based taxes the auditor will refer to the actual return and/or electronic copy of the return, and:
  - if a return is signed and dated on or before the statutory due date, without extension, the date for SOL purposes will be the statutory due date.
  - if a return, filed on extension, is signed and dated before the extension due date, the date for SOL purposes will be the signed date.
  - if a return is signed and dated after the due date, with or without extension, then that date will control for SOL purposes, unless the signed date appears to be an error.
  - if a return does not contain a signed date, then the internal date stamp should be used. If the return does not have an internal date stamp, then the MASSTAX assessment date should be used. However, if the return is date stamped within the DOR grace period then the statutory due date should be used.
  - Note: Internal date stamps or processing dates should not be utilized until it is proven that the signed and dated return is incorrect.
  - Note: The auditor should examine each return under audit to determine the earliest expiration date. The oldest period filed is not always the oldest period under audit.
  - Failure to File Cases - When an auditor is assigned the case of a non-filer, the Non-Registrant check box in Audit WorkBench-Period Details should be used to indicate that the taxpayer is a Non-Registrant or Non-Filer. This will allow the SOL to be null for reporting purposes. When returns are secured, the SOL date must be edited immediately to reflect the proper SOL date.

**Form Completion** (\* Fields to be pre-populated based on the Audit WorkBench case information.)

- Taxpayer Name\*: Enter the correct name of the entity. If a combined return, enter the principal reporting corporation and subsidiaries and on an attached schedule listing the subsidiaries and have the taxpayer sign.
- Address\*: Enter the correct mailing address of the entity.

- Taxpayer Number\*: Enter the FID business number or social security number if applicable.
- Tax Type\*: Enter the correct statutory citation of the tax type being audited and Chapter 62C.
- Reporting Period(s)\*: Enter the beginning and ending dates of the report period(s) being extended based on the taxpayer's reporting methods applicable for the tax type:
- Extended To: Enter the date to which the assessment date for the period is to be extended.

**The maximum time extension for any report period is 12 months per Division policy. Any additional extension of time per subsequent agreement must be approved by regional management.**

Note: The actual date of filing for each return period under audit must be determined by the auditor with the earliest date for expiration of the time for assessment being entered into Audit WorkBench-Period Details: Statute of Limitations. The case auditor and supervisor/manager are jointly responsible for establishing, monitoring and protecting the statute of limitations for assessment on each return period assigned for audit.

In cases where the actual date of filing cannot be firmly established at the time of assignment, the auditor is to determine the time allowed for assessment based on the statutory due date for filing such return(s) pending the establishment of the actual date of filing.

### **Handling of Waivers**

#### **Proof of Claims Must be Submitted before the Bar Date**

- In a case where the taxpayer declares bankruptcy while the audit is in progress, the extension date on the waiver should not be beyond the bar date. However, if an extension has already been obtained that is beyond the bar date, the auditor should take extreme care to inform the supervisor so that proper documentation can be timely submitted to the Bankruptcy Unit to file a proof of claim.

#### **Failure of the Taxpayer to Execute Waiver**

- If a taxpayer fails/refuses to properly complete and submit an extension of time form within twenty days from date of mailing/delivery, the case auditor is responsible for bringing this fact to the attention of the supervisor/manager for a determination on whether:
- Additional time should be granted to properly execute the waiver;
- There exists sufficient information on which to proceed with the issuance of a Notice Of Intention To Assess (NIA) or;

- In those instances where no field time has been logged, periods may be deleted from the case assignment.  
Proper documentation will be maintained in the electronic audit case folder to evidence and support the actions and decisions relied upon in the disposition of this issue for each audit assignment.

### **Processing of Waivers Signed and Dated by Taxpayers**

- The taxpayer or the taxpayer's authorized representative should sign the agreement.
- The case supervisor/manager should sign and date the agreement as a representative of the Commissioner after it is signed by the taxpayer representative. Auditors may sign the waiver per DOR's Delegation of Authority.
- The person signing as "Taxpayer" must be authorized to sign the document per the Power of Attorney (Form M-2848).
- Upon receipt of the waiver (one), the auditor date stamps the form and submits the waiver to his/her supervisor/manager for review and approval. The supervisor/manager or their designee makes the appropriate SOL update in Audit WorkBench.
- Once the supervisor/manager or their designee makes the appropriate SOL update, the executed waiver must be scanned and attached to the proper electronic audit case folder in Audit WorkBench.
- Once the appropriate SOL update is made and the executed waiver is scanned and attached, the fully executed waiver is sent to the taxpayer.
- Where a waiver is obtained during the conduct of a field audit, the auditor must indicate in the Audit WorkBench-Case Log and Case Plan that the waiver has been executed, the SOL was updated and taxpayer has received a copy of the executed waiver.

### **Processing of Office of Appeals (OOA) Waivers (Form B-37)**

- The processing of the Office of Appeals (OOA) waiver forms for cases involving section 26 (b) pre-assessment conference requests and/or settlement consideration is essentially the same. The only exception is that the responsibility of preparing, forwarding, and processing these forms rests with the supervisor/manager since the case has been subjected to exit conference procedures (See Chapter 5, Audit Completion-Documentation of Findings & Administrative Remedies).

- For all Form B-37's, the SOL/Waiver date to be entered on Audit WorkBench is 12/25/2027.

## **Monitoring the SOL**

### **Reports and Memos for Monitoring the Statute of Limitations**

- The Statute Protection Report is available through Reports Navigation in Audit WorkBench. Management can access this report on a weekly basis to monitor the Statute of Limitations (SOL). At the end of each month, the auditor is responsible for reporting on all cases that have 90 days or less remaining on the statute. The auditor must furnish the supervisor a written response concerning the status of the case.
- Supervisors and managers are responsible for monitoring the SOL through the mandatory review of cases in progress and Technical Time Reports timely to ensure that:
  - no cases will expire before the first day of the next month;
  - waivers are being secured, if an NIA is not going to be issued within the month; and
  - all updates have been done on waivers received.
- Management is responsible for conducting monthly reviews of the statute of limitation report to enable timely corrective action in protecting against the expiration of the statute of limitation for assessment on any case in which taxpayer contact has been made.
- Each supervisor or manager will prepare a monthly SOL report to be submitted to the Chief of Bureau.

#### **Footnote:**

See Assessment Regulation: 830CMR 62C, 26.1.

## Chapter 2

### Pre-Audit Research

#### Introduction

The auditor becomes familiar with the taxpayer's filing history in this phase of the audit process. The auditor should perform a review of the taxpayer and the business to be audited before the taxpayer is contacted. Additional research continues through taxpayer contact and preliminary testing.

Information for review is available from various sources: current and prior audit files; audit management; the Internet; MASSTAX; DTAX (i.e., financial information, demographic information, business details and accounts); and other governmental agencies as well. This information should aid the auditor in:

- Learning more about the taxpayer's reporting methods and business operations;
- Understanding the taxpayer's filing and payment history;
- Establishing preliminary objectives for the audit plan; and
- Identifying and researching possible industry specific problem areas.

#### **Audit Workbench-Create/Associate New Period Case Creation**

When a taxpayer has been selected for audit, the supervisor/manager or their designee will create and associate the audit period and SOL for each case assigned using the most current audit period end date. Once the audit period has been associated, the auditor will be notified through Audit WorkBench (AWB)-My Inventory and an auto case log entry will be created and entered into the Audit WorkBench (AWB)-Case Log.

The source of audit is assigned during Audit WorkBench (AWB)-Case Creation through the Case Attributes pane. The source of audit assignment whether from a referral or from an automated RFQ should be documented by the auditor in the Audit WorkBench (AWB)-Case Log through a manual case log entry. The source of audit should be included in the audit narrative and indicated as such in the Audit WorkBench (AWB)- Case Plan.

During the case creation process the case type, the case sub type and the reason for the audit also known as the case attributes dictates how the electronic audit case folder is assembled in other words these case attributes associate the proper Case Plan, Notice Templates and Approval Hierarchy to each case in Audit WorkBench.

## **Establishing Statute of Limitation SOL**

Once the SOL has been established for the periods associated to a case, the SOL will be tracked in Audit WorkBench. Management or their designees will have access to run the Statute Protection Reports which are used to monitor and protect the Statute of Limitation for periods under audit.

## **Case Log**

Once the case has been assigned, the auditor must record all audit activity in the Audit WorkBench (AWB)-Case Log on a daily basis. A normal working day should be recorded as 7.5 hours and designated as field time, office time or telecommuting using the location drop down menu in the Case Log entry pane.

The Case Log will automatically record case actions taken within the electronic audit case folder as designated within the Audit WorkBench Manual. The audit hours charged to a case must be recorded on a daily basis through a manual case log entry. Edits and deletions can be made to manual Case Log entries only.

A complete review of the Case Log can be accomplished by sending the Case Log to an HTML file to view entries and details.

## **Discover Tax (DTAX) & MASSTAX Taxpayer History**

The history is a computer-generated summary of all transactions relating to a particular taxpayer account. Each tax return filed becomes a part of the tax history. The DTAX warehouse contains a history of all taxes recorded within the MASSTAX system for transactions posted to taxpayer accounts after 1998. To review this information, access Audit WorkBench to find a particular taxpayer. Scroll down the Accessed Portfolio node to gain access to all of the DTAX nodes such as tax filings and line item details, ID#'s, asset information, vehicle registration information and summaries of existing Audit WorkBench cases.

The auditor should determine if the filing history is current in order to have the latest updated information and to identify delinquent periods requiring enforcement action.

The auditor should note any tax types that may apply to the taxpayer but which the taxpayer has not registered. The auditor must resolve all registration and filing issues during the course of the audit.

The auditor should note any areas in the taxpayer history that are out of the ordinary. For example, a period with a self-assessment that is out of line with other periods (recognizing seasonal variability). The auditor must investigate and resolve all questionable tax reporting issues.

If a prior audit exists, the MATIS information will be recorded in the MASSTAX system.

If a business commenced operations or opened a new location during the audit period, the auditor should determine on audit if any business activity occurred prior to the registration date and how it was reported. In addition, there may be issues with recordkeeping, reporting the correct tax or income apportionment.

The Standard Industrial Classification Code (SIC) is found on the DTAX under Business Information and is also found on the DLII screen in MASSTAX. This information should be compared to the business description stated on the income/corporate return. This code and description are useful in determining the area of law or industry that may require pre-audit research.

If a business ceased operations during the audit period, an auditor should review transactions involving the liquidation of assets and distributions to shareholders for the purpose of identifying audit issues to be addressed on audit or the referral to another tax area.

The return data will be listed by period for each business entity or business location that was active within the audit period. A return period that is omitted or missing, indicating a delinquency, must be investigated and resolved on audit.

When MASSTAX indicates a 610R within the audit period then the period would still be within the general SOL and the taxpayer would be required to have records for that period. Consequently, you may inquire about the status of any return within the audit period. For periods outside the audit period the following general rule applies, non-filer assessments should not be made after the posting of a 610R unless the auditor has compelling information about the period in question that would conclude otherwise. In such instances, the auditor should discuss the matter with his/her supervisor or manager and only proceed with a non-filer assessment if given explicit direction to do so.

In an effort to maintain an accurate and current taxpayer history and to avoid duplication, auditors are required to comply with the following procedures during the audit cycle.

**Each time a taxpayer record is retrieved in MASSTAX:**

- Browse "Case Notes" (CSNT) and "Taxpayer Notes" (NOTE) to determine the actions already taken on the taxpayer by any other audit region or bureau within the Department of Revenue.

### **Upon assignment of a case:**

- Enter a "Taxpayer Note" (NOTE) to identify the Audit WorkBench (AWB) Case ID number, name of auditor assigned to the case, the date the case was assigned and the auditor's region and telephone number.

### **Upon issuing either a Notice of Inquiry Letter, Notice of Failure to Register, Notice of Failure to File, or a Notice of Insufficient Return:**

- Enter a "Taxpayer Note" (NOTE) to document the fact that these notices were issued. The "Taxpayer Note" should include, but not be limited to, the name of the notice, date of issuance, tax type and periods.

### **DTAX Information**

The information found in the data warehouse is a valuable research tool. The taxpayer demographic portfolio allows access to the DTAX Research component. The following research tools are available and updated as changes to a particular demographic occur and should be used to assist an auditor with his/her pre-audit research activities:

- The financial information provides accounting period details for returns posted to MASSTAX.
- The source data information provides a listing of the source origination for financial information warehoused.
- The relationship information provides a listing of entities "related" including Federal Identification Numbers.
- The asset information provides Registry of Motor Vehicle information including plate numbers and vehicles identification numbers for each vehicle registered to a particular entity.
- The accounts and attributes information provide tax registration history for both federal and state tax types including the effective date of the registration.
- The sales information is provided on a yearly basis by United States Customs.
- The notes information provides a means to enter manual notes relevant to the taxpayer.
- The taxpayer cases information provides the prior audit activity records as well as the current audit records posted to Audit WorkBench.

### **MASSTAX Terminal Inquiries**

There is a great deal of information available to the auditor through terminal inquiry. The information used in an audit is not limited to the account being audited. Inquiries can be made to obtain information on related entities, customers and vendors. This section references required inquiries and data purification action required on audit as well as pre-audit activities. Data Purification is a mandatory component of the audit process. Identification and resolution of incorrect data should be conducted as early as possible

during the course of the audit and must be documented in the completed electronic audit case folder.

Any incorrect financial transactions should be corrected using the following forms: Financial Transactions Corrections - TP-2  
Period Summary Corrections - TP-6 Financial  
Transaction Transfer - TP-11

All forms should be prepared and submitted electronically to the Audit Division's designee for processing and included in the electronic case folder through Audit WorkBench (AWB)-Attachments.

Additional screens are available within the MASSTAX Systems for your use as necessary in the performance of research or other assigned duties.

### **Prior Audits**

The auditor can determine if there has been a prior audit by checking the MASSTAX audit history screen (AAHT). Additional information can be obtained from terminal inquiries including "Case Notes" (CSNT) recorded by another division and reviewing DTAX for completed case activity on Audit WorkBench.

If there has been a prior audit:

- Note the prior audit period to avoid re-auditing the same periods.
- Obtain prior audit case folder and review findings. Discuss them with the taxpayer to determine if corrective action has been taken. Note if corrections were made. Often, there is a period early in the audit, prior to the change, where adjustments are necessary.
- Review prior audit information via the View Link on Audit WorkBench (AWB) cases.
- If the taxpayer disagreed with the audit, follow the audit through the appeals process to see how appellate decisions affected the audit.
- Study audit procedures, plan and notes of the prior audit to:
  - become familiar with records retained;
  - use as a guide to help estimate the time required for completion; and
  - see if the taxpayer contact is the same as on the prior audit. If not, this change may indicate policy or reporting procedure changes in the audit period.

A prior audit should not serve as a blueprint for the current audit. Changes in tax law and business operations occurring since prior audits are important areas to cover. Researching the Legal Library found on DORNET can assist in identifying recent changes in tax laws through Letter Rulings, Technical Information Releases, DOR

Directives and recently enacted Regulations. The prior audit can be used to enhance the current auditor's use of time by identifying records examined, the difficulties of certain audit methods and areas where no errors were found that may require less emphasis in the current audit.

An auditor can request copies of prior audits through the Department's automated RM-4 Tracking System. Requests go to the Records Management Bureau, which will locate and forward to you the audit file or an explanation of why it cannot complete your request.

### **Researching Taxability**

Through examination of the taxpayer's filing history and other information in the audit file, the auditor will have an idea of the type of business or industry being audited.

The auditor should make use of the following in researching an issue:

- Tax Law and Rules - each office has copies of the tax statutes, DOR written pronouncements and administrative rules which are available through the MASSTAX Legal Guide and DORNET. The auditor should be familiar with the rules governing issues surfacing on audit.
- Audit Division Directives - occasionally, Audit Division directives are issued on legal and procedural issues that require guidance called Legal Advice Memorandum's- LAMs and are available through DORNET and not for external distribution.
- Publications - informational tax guides have been prepared by the Department on various tax areas. The Legal Library on DORNET references Letter Rulings, Technical Information Releases, DOR Directives and Regulations. This reference material can also be found in the MASSTAX Legal Guide. When used, the auditor should ensure that the tax guides are current with the latest tax law.
- Discussions with Supervisor/Manager - if the research has not provided the answer to taxability issues, the auditor should then discuss the issue with the supervisor/manager. If possible, your supervisor/manager should discuss the issue with their legal partner to determine whether he/she has encountered the same issue. The auditor and the supervisor/manager may need to consult the audit manager/director for the answer. If the auditor does not get an answer from these discussions, guidance should be requested from the Bureau Chief upon approval from management.
- Resolution By Bureau Chief - the audit manager/director will only request an answer from the Bureau Chief after all of the aforementioned efforts to resolve a tax issue have been exhausted. Resolution by the Bureau Chief should not be requested at the pre-audit stage, but only after the auditor thoroughly understands the taxpayer's situation, has researched it and still cannot resolve it.

## **Other Sources of Information:**

Depending on the size, complexity, etc., of the taxpayer to be audited, sources of information such as the following may be considered prior to beginning field work.

- Telephone Directory Yellow Pages can be used to identify locations and the types of services provided by the taxpayer as well as phone numbers;
- DTAX Warehouse business information;
- Corporations Division through Secretary of State Website [www.sec.state.ma.us](http://www.sec.state.ma.us) - Can be used to search the Corporate Database to identify business location, year-end status and corporate officer information;
- Company Web Pages and other sources of information are available on the Internet;
- Directory of Corporate Affiliations - Lists parent corporations, their divisions, subsidiaries and even plant locations. This directory gives a quick view of the corporate structure, interests, types of business activity (via SIC codes), sales volumes, contact names and phone numbers; and
- Security and Exchange Commission 10K Reports - Available online or obtained from the taxpayer.
- Occasionally, the prior audit file will include magazine or newspaper articles about the taxpayer's business. These should be read in their entirety for items of interest.

## **Audit Notification**

Telephone contact with the taxpayer should be made prior to issuing the appointment letter in order to facilitate the scheduling of the audit.

The auditor must inform the taxpayer of the Department's intention to conduct a field examination by issuing the following documents sent by first class mail or electronically through secure mail:

- Notice of Audit Appointment Letter
- Checklist/Information Document Request ; and
- A copy of "The Audit Process"

These pre-populated notices are located in Audit WorkBench (AWB)-Notice Generation. A copy of the letter and checklist is retained in the electronic audit case folder through Audit WorkBench (AWB)-History where these notices can be viewed, but not edited to represent an image of exactly what was sent to the taxpayer. Any notices issued using the Audit WorkBench (AWB)-Notice Generation templates will create an automatic case log entry based on the actions performed within the electronic audit case folder.

Note: Manual case log entries must be used to capture the hours for specific actions taken on a case and can be edited, if necessary. Auto case log entries cannot be edited.

If the taxpayer elects to provide the original records required to conduct the audit in the DOR office, a Taxpayer Document Receipt Form must be completed, signed and dated by each party in both instances where the records are received from the taxpayer to the DOR Representative and when the records are returned by the DOR Representative to the taxpayer. This procedure must be documented in the AWB-Case Log.

If telephone contact cannot be made, the auditor must mail the Notice of Appointment Letter, or a Notification of Audit with enclosures, by Certified Mail.

In addition, the auditor should consider and decide whether the issuing of other forms are required at the time of audit notification, such as the Notice of Failure to File a Return for identified delinquent periods, a Form A-37 in order to timely execute an extension of time for assessment due to an imminent expiration period or a Form M- 2848 (Power of Attorney).

As part of the auditor's pre-audit research, the auditor should have reviewed the filing status of the taxpayer regarding all tax types for which the taxpayer would be responsible. If upon such review, the auditor finds that a taxpayer is a non-filer for any such tax types, then he/she should issue an NFF along with the Notice of Appointment Letter for any periods where no automated failure to file notices have been issued. The auditor should then check the filing status of each case in their inventory on periodic basis as directed by Bureau Management and if they discover any additional non-filed periods, then a NFF should immediately be issued for periods where no automated failure to file notices have been issued. In addition, such a review must also be performed when preparing the case for final supervisory approval.

Note: It is important for auditors and supervisors to maintain accurate information in Audit WorkBench-Contacts. This information is replicated in Audit WorkBench-Correspondence Generation in the recipient data field. All Audit Forms in Audit WorkBench-Correspondence Generation can be found using the drop down arrow.

### **Telephone Contact**

In contacting the taxpayer via telephone call, the auditor should:

- Identify himself/herself and the purpose of the call;
- Discuss the tax or taxes to be audited;
- Establish an appointment for the opening conference and a date to commence the audit. Verify the taxpayer's location and get directions;
- Tell the taxpayer what records may be required and that additional records may be necessary as the audit proceeds;
- Discuss the availability of records in electronic format;
- Discuss the option of using Computer Assisted Audit Techniques (CAATS) as a tool for conducting the audit;
- Determine the location of the records. If the records are outside of the audit office assignment area, then a transfer of the audit should be considered;

- Inquire about available working space;
- If possible, determine the taxpayer's understanding and interpretation of the laws and rules with emphasis on recent law changes;
- Observe the rules of professional conduct;
- Complete a list of questions to ask the taxpayer during pre-audit research to make the initial contact more professional and efficient for both the auditor and the taxpayer;
- Obtain any other information that may be needed before the opening conference takes place, especially for an audit that requires out-of-state and out-of-town travel; and
- Grant a reasonable request by a taxpayer to delay the audit with supervisory approval. At this time, the taxpayer must consent to sign the Agreement to Extend the Time for Assessment of Taxes, Form A-37 (waiver), otherwise a postponement should not be granted. The auditor should also note in his/her case log the reasons for any delays at the start of or any other time during the audit review. In granting reasonable delays, a letter of confirmation should be issued to the taxpayer. A request by a taxpayer or legal representative for a delay of over 60 days should be made in writing and approved by his/her supervisor before such request is granted.

## Chapter 3

### **Audit Planning and Documentation: The Electronic Audit Case Folder**

#### **Introduction**

The Audit WorkBench (AWB)-Case Plan contains the sequence of tasks for the specific audit types and includes a detailed account of tasks performed during the course of the audit. The Case Plan generally includes the following components:

- Research-Pre-Audit Analysis;
- Planning-Opening Conference and Initial Audit Review;
- Examination-Audit Review and Documentation;
- Findings and Reporting-Supervisory Review and Exit Conference Procedures.

#### **Record of Audit Planning, Activities and Results**

The Case Plan covers a wide scope of audit activities and responsibilities associated with the conduct of a tax examination by audit personnel. The Case Plan's check box structure is designed to enable the auditor to check off tasks upon completion while the audit is in progress and serves as a reference to guide the auditor towards completing the required tasks in preparation of the electronic audit case folder for supervisory approval.

#### **Case Plan**

The Case Plan is divided into Primary Tasks and Subtasks and captures the required steps which must be performed during the course of an audit. Primary Tasks will auto-check once all associated Subtasks are completed. Subtasks can be completed in random order allowing for the flexibility of workflow, but a Primary task will only auto-check when all prior Primary Tasks are performed.

An auto case log entry will be posted to the electronic audit case folder when all of the Subtasks are completed within the Primary Task.

The electronic Post-it feature allows the auditor to manually enter notes on the Case Plan to alert management to important details or information which may be relevant during the review of the case.

**Case Plans are provided in detail within each tax specific chapter of this manual.**

The following are common components among all case plans; however procedures vary between the field bureaus and tax types.

Differences are noted, especially in the opening and exit conference proceedings; the New England Audit Bureau handles opening conferences with the supervisor, auditor and taxpayer present while discussing the audit parameters and the Multistate Audit Bureau conducts their opening conferences with the auditor and taxpayer present.

Multistate Audit Bureau managers only attend exit conferences if there are unresolved audit issues. If so, the audit work papers and final assessment summary are revised in accordance with the exit conference determinations and sent to the taxpayer.

- **Research:**
  - Pre-audit Analysis and Contact
  - Schedule an opening conference
- **Planning:**
  - Opening Conference
  - Initial Audit Review
- **Examination:**
  - Audit Review
- **Supervisory Review, Case Closing & Exit Conference Procedures.**

## **Case Log**

The Audit WorkBench (AWB)-Case Log is a detailed chronological record of all activities related to the assignment and conduct of the audit. The Case Log is completed on a daily basis to document all interviews, discussions, audit work, records examined, identity of all participating individuals and correspondence either issued or received.

The Case Log should document:

- The source of audit assignment and the criteria used in its selection;
- The opening conference, in particular, the presentation and discussion of the Taxpayer Bill of Rights and how it relates to the audit process and avenues of appeal;
- Any delays in the start of the audit or the completion of the audit;

- All entries should be factual in nature and pertinent to the case. For example, the Case Log should not have entries which state that the Taxpayer cannot tell time and does not know how to organize its information. Instead, for example, the Case Log entry should read that the auditor met with the Taxpayer on xx/xx/xxxx; the Taxpayer was one hour late for the appointment and it was the third appointment in which the Taxpayer showed up late without any records.

There are two types of log entries: manual and automated. All entries record the auditor's name, category, time/date stamp, last update date, hours and location of the action.

Manual Case Log entries are user-created by clicking the Add button where you assign the entry a date, category, hours and location, which are the only way to capture hours dedicated to a specific case. Enter the text and click Save to record the entry. Fixed values of the manual entry are Created By and Date Entered.

Automated Case Log entries are created when certain case actions are taken within the electronic audit case folder and cannot be edited.

The Export feature allows the auditor to send the Case Log to an HTML file for a complete view of all entries and details.

## **Audit Work Papers**

Auditors use standardized Excel spreadsheets for work papers and attach them to the case in Audit WorkBench (AWB)-Attachments.

### **A. Basis and Content of Work Papers**

Audit Work papers are an essential component of an audit. Work papers serve several important functions:

- Provide a historical record showing all the audit work performed;
- Contain the basis for the auditor's conclusions and proposed adjustments, if any; and
- Provide support for audit assessment determination if the taxpayer appeals.

The work performed and the conclusions reached by an auditor must be adequately documented in the audit work papers. Using the standardized Excel templates, worksheets can be easily created from the established template library, and may also include merging taxpayer provided records into the workbook. The content of the work papers should be dictated by the nature of the audit:

- Work paper volume will vary from case to case due to the condition of the financial records, statements, schedules and degree of examination required;

- Work papers should be restricted to matters that are relevant, material and directly related to the audit objectives;
- Each distinct subject should be covered by a separate schedule of the work papers;
- The sample selection and the sample size are determined using data analysis through the statistics function of ACL and Statistical Audit, an approved propriety software developed by our contracted statistician;
- After tests are made and the detail analysis is performed, auditors should record their findings using specific worksheet templates;
- Single-error block projections, multiple-error block projections and statistical sample projections (CAATS) are easily recorded in the templates provided based on the agreed upon method; and
- The auditor may incorporate as part of the work papers any work papers prepared by the taxpayer that are part of the books and records. All examined documents, invoices, vouchers, etc., must be clearly identified and, if included, must be scanned and attached to the electronic audit case folder in Audit WorkBench (AWB)-Attachments.

## **B. Format of Work papers**

Work papers requires certain uniformity to make them useful. Work papers should incorporate the following standards:

- Each standardized worksheet is created from a template workbook which allows the auditor to use only the schedules necessary to record his/her findings based on the tax type and records examined, and is labeled as such on the Worksheet Tab;
- Each work paper in the workbook will be auto populated by its case details in the Filings sheet, including tax type, audit periods, taxpayer ID number, and demographics, auditor information and filing details of the audit period(s);
- Each examination impacting tax is linked to the Audit Summary sheet for supervisor/manager review which can be marked final or revised and the results will then be posted to Audit WorkBench (AWB)-Assessments;
- Each spreadsheet-based work paper must have a descriptive heading, identifying the taxpayer, ID number, AWB or MATIS Case ID number, audit period(s), auditor name and ID, date, page number and title of the work paper;
- Each spreadsheet-based work paper must include proper column headings and cross-references from other schedules or work papers when appropriate;
- Each spreadsheet-based the work paper should be kept in logical groups;
- Upon completing the work papers, the auditor should review his/her work to see that it is accurate; and
- Each spreadsheet-based work paper including supporting documentation must be attached in Audit WorkBench (AWB)-Attachments using suggested filenames and attachment categories for easy identification and review by supervisors/managers.

### **C. Summaries of Work Papers**

Audit work papers created through standardized templates will form an assessment package containing the following information:

- Filings which displays the filing history review of return line-items;
- Penalties which calculates manual penalties on the tax due, when applicable;
- Audit Summary which displays the taxable amounts for each worksheet included in the assessment and calculates the tax on the total;
- Tax Summary which displays total tax from each examination as well as credits from filings and penalties; and
- These total tax figures are posted to Audit Work Bench (AWB)-Assessments and interface with AAHT in MASSTAX to generate the Notice of intention to Assess (NIA).

Audit work papers created using spreadsheets to form the basis of the audit assessment should include the following:

1. Detail transaction listings for each examination;
2. Summary spreadsheets which tie together groups of work papers that relate to a particular audit examination, verification or exercise;
3. Assessment Summary which reflects the total tax due or over assessment figures per audit based on each examination and/or summary spreadsheets; and
4. These figures will be entered into Audit WorkBench (AWB)-Assessments and interfaced with AAHT in MASSTAX to generate the Notice of intention to Assess (NIA).

### **D. Volume of Work Papers**

The volume necessary to efficiently complete the audit and convey its results is dependent on the auditor's judgment and the scope of the audit.

### **E. Work Papers Reviews**

All final work papers should be reviewed by the supervisor or manager before presentation to the taxpayer or taxpayer's representative to ensure that audit opinions are clear and objectively evidenced and that there are no unanswered questions or other loose ends. Whenever possible, the supervisor or manager will review the preliminary work papers. In addition, all preliminary work papers must denote the fact that they are subject to change based on supervisory or managerial review. There may be several versions as the taxpayer produces additional documentation throughout the course of the field work.

- Several points should be considered while conducting a review of the work papers:
  - Was the Case Plan followed?
  - Did the auditor comply with any necessary specific instructions?
  - Do the work papers evidence the work performed and sufficiently support the audit findings?
  - Were the conclusions reached reasonable and valid and supported by statute?
  - Were Audit Division rules on work papers followed?
  - Were the approved standardized templates used?
  - Are there sufficient detail documents to support the auditor's findings on contested issues (e.g., contracts, purchase orders, freight bills, certificates, etc.)?

Well-organized cases and effective instruction by the supervisor can help ensure the inclusion of only relevant documents in the work papers.

## **F. Controls for Work Papers**

The auditor should know exactly where the work papers are at all times during the conduct of the audit to protect the confidentiality of the information.

Upon completion, and after review and approval by the supervisor, one copy of the work paper schedules are given to the taxpayer or taxpayer's representative and the original work papers and subsequent revisions remain in AWB-Attachments as part of the electronic audit case folder.

### **Audit Narrative**

The Audit Narrative should be a reporting of steps covered in the completion of the audit process, including the assignment of the case, the opening conference, the examination of the records, the audit findings including the statutory cites pertaining to the issues surrounding the exceptions listed on the audit work papers and the conclusions based on the best information and belief presented by the taxpayer, the exit conference and the taxpayer's position regarding these findings. The Audit Narrative should be prepared as a word document then added to the electronic audit case folder through Audit WorkBench (AWB)-Attachments.

The following audit activity should be included in the audit narrative:

- Source/Basis of Audit Assignment-the auditor should state the reason for the case assignment such a generic and specific source of audit code, if applicable.
- Overview of Taxpayer-the auditor should include information about the taxpayer such as:

- The taxpayer's type of business such as contractor, manufacturer or retailer just to name a few and the exemptions that the taxpayer may or may not be entitled to as a result of their status;
  - Information as to whether the taxpayer is classified as a manufacturing corporation;
  - Type of ownership such as corporation, partnership, sole proprietorship or Massachusetts Business Trust;
  - The business locations in MA or facilities out-of-state, the date the business began in MA and the number of employees;
  - Applicable tax registrations along with the filing history including outstanding-filer periods (O/F), None Returns or Use Tax reported;
  - The name of the contact person(s) including title, phone number and e- mail address, outside representation, if any;
  - List whether a Form M-2848 (POA) was obtained;
  - The taxpayer's bank and account number and responsible person (transaction tax cases, excluding Multistate);
  - If any of the following notices are issued to the taxpayer then document as such: Notice of Failure to File Returns (NFF), Notice of Failure to Register and File Returns (NFR) or Notice of Incorrect/Insufficient Return (NIR);
  - List whether Form A-37(waiver) was executed;
  - The prior audit history should be reviewed, if any, including the prior completed case folder discussing any potential audit issues that should be addressed; and
  - The related taxpayers, tax types and Case ID number should be referred to in this section.
- Records Examined-the auditor should review and include the tax specific records examined during the audit as well as the records common to all cases such as:
    - Prior completed case folder; and
    - Federal and MA Corporate Excise tax returns.
- Detail Summary of Audit-the auditor should list the areas examined and the exposure or the result of the examination, if any:
    - Each examination finding should include the sample periods, if any, and how the sample size was selected as well as whether or not a Notification of Sampling and Representative Test Agreement was issued and signed by the taxpayer and/or taxpayer's representative (transaction tax cases only);
    - Each examination should include, in general, the type of items found subject to tax and why, but the auditor may want to include specific references to certain issues and were any items listed based on Letter Rulings, DOR Directives, Technical Information Releases or, Regulations; and

- Each examination should include the taxable totals with a breakdown of tax attributed to each audit issue or adjustment and the last paragraph of the summary should list the overall tax deficiency/over assessment.
- Federal/Mass Audit History-the auditor should include whether or not the taxpayer was previously audited by DOR referencing the audit period and case number as well as whether the case went to the Office of Appeals (OOA), filed Form ABT (formerly Form CA-6), case pending litigation including the docket number or whether or not any federal audits were disclosed during the audit time frame. Whenever applicable, the auditor should identify the status of the latest IRS audit (RAR), the date finalized and note the date the last federal changes were reported.
- Taxpayer's Position and Auditor's Recommendation-the auditor should explain the conclusion of the audit:
  - Does the taxpayer and/or the taxpayer's representative agree with the audit findings, if not, include which specific issue(s) or adjustment(s) will be appealed and why;
  - Did the taxpayer and/or the taxpayer's representative state whether or not they would request a pre-assessment conference and/or settlement consideration;
  - Does the taxpayer wish to receive a Notice of Intention to Assess (NIA) or will they file Amended Returns;
  - Did the taxpayer state whether or not they would implement systems to properly track and report tax in areas where they were deficient? Does the auditor think the taxpayer will do a better job; and
  - Does the auditor recommend another audit for subsequent periods? If so, please provide an explanation as to why.

## Chapter 4

### Opening Conference

#### Introduction

The opening conference is a meeting between the auditor and the taxpayer or taxpayer's designated representative, prior to beginning the examination of the taxpayer's books and records. This conference is generally the first face-to-face meeting between the taxpayer or representative and the auditor.

Supervisors from the New England Audit Bureau should be in attendance at most opening conferences. If the supervisor is unable to attend, the auditor should inform the taxpayer of their supervisor's name, telephone number and electronic mail (e-mail) address should questions arise that the auditor is unable to address.

Audit Managers from the Multistate Audit Bureau typically do not attend opening conferences due to time constraints, travel requirements and office logistics. Again, auditors should inform the taxpayer of the audit manager's name, telephone number and e-mail address should the taxpayer have questions.

The opening conference is the foundation of a good audit and generally sets the tone of the auditor's dealings with the taxpayer. The taxpayer should be left with the impression that the auditor will be honest and fair, flexible and interested in serving the taxpayer, and willing to educate and assist the taxpayer. The auditor must ensure that all taxpayer records are kept confidential and DOR equipment is maintained in a secure environment at the audit site. In addition, all e-mail communication should be sent through secure mail.

During the opening conference, the auditor should make the taxpayer aware of the purpose of the audit and what is expected of the taxpayer as well as what the taxpayer may expect of the auditor.

#### Topics to Discuss at Opening Conference

Upon arrival at the taxpayer's place of business, the auditor should properly introduce himself or herself providing proper identification if requested. Then the auditor should hold a preliminary discussion with the taxpayer about the business and the audit and address any questions that were not covered during telephone contact, including the following:

- The scope and objectives of the audit;

- A discussion of the Taxpayer Bill of Rights, with an emphasis on the audit process and appeal rights, including pre-assessment conferences and settlement consideration with the Office of Appeals (OOA);
- Availability and location of records to be examined referencing the checklist/Information Document Request Form which was sent along with the Notice of Audit Appointment Letter;
- Records that are unavailable should be discussed to determine the cause and documented in the Audit WorkBench(AWB)-Case Log;
- Discuss and document the need to secure an executed Agreement to Extend the Time for the Assessment of Taxes, Form A-37(waiver) especially if the taxpayer cannot provide documentation in a timely fashion;
- Discuss the allowance of a reduction in interest rate if the length of a field audit exceeds 18 months and is measured from the length of time from the opening conference date and the NIA date;
- What audit procedures may be used;
- Verify historical information with the taxpayer and perform necessary file maintenance;
- Update information obtained through pre-audit research and/or the necessity of any required file maintenance (CRC's, applications, etc.) to be completed;
- Explain that any DOR enforcement action in process will continue even though an audit is in progress. The auditor should always have the taxpayer file any delinquent returns that are due; and
- Request a tour of the facilities to understand the taxpayer's business, products, possible manufacturing exemptions and utilization of assets.

All opening conference activities must be documented in the Audit WorkBench (AWB)- Case Log.

Note: Opening Conference procedures are discussed in detail within each tax specific chapter of this manual.

### **Interest Charges after Audit**

Administrative provisions within the Fiscal Year 2012 Budget, "The Acts", allows for a reduction in interest charges if the length of a field audit for certain tax periods filed by a taxpayer exceeds 18 months and results in a deficiency assessment issued by the Department of Revenue (DOR). The length of audit is measured from the opening conference date to the date the Notice of Intention to Assess (NIA). The new interest calculation in accordance with G.L. c. 62C, § 32(f) will apply to interest accruing on deficiency assessments where the audit resulting in the deficiency assessment is commenced after July 1, 2011.

The Notice of Audit Appointment incorporates the new language regarding G.L. c. 62C, § 32(f) in which the date of the audit appointment will serve as the opening conference date. A waiver form was developed for use in conjunction with G.L. c. 62C, § 32(f).  
Form A-32, Consent to Waiver or Toll the Time Period Under Chapter 62C, section

32(f), has been approved with both Option 1 and Option 2 available for the taxpayer's selection. By selecting Option 1, a taxpayer is foregoing any right to a reduced rate of interest under c. 62C, § 32(f). By selecting Option 2, the taxpayer agrees to extend the 18 and 36 month periods in § 32(f) by an agreed upon set period of time (i.e. an additional 2 or 3 months). Option 2 can be subsequently extended by executing another agreement.

If applicable, § 32(f) reduces the interest rate by 2 percentage points, not to go below zero, for NIA's with issue dates that fall between 18 months and 36 months after the opening conference date. The reduced interest rate only applies interest charges accruing after the 18 month period. There is no interest rate reduction to any interest charges accruing prior to the 18 month period. If the NIA issue date exceeds 36 months from the opening conference date, the interest rate may be reduced by 2.5 percentage points not to go below zero. The 2.5% reduction only applies to the interest accruing after the 36 month period under § 32(f). For the reduced interest rate to apply, DOR must determine that the taxpayer complied with all requests for information or documentation made during the audit period with substantial promptness and completeness, and the taxpayer was not otherwise responsible for the extended duration of the audit. A taxpayer may appeal the Department's determination that the taxpayer did not comply with an audit request for information or documentation with substantial promptness and completeness to the Appellate Tax Board along with any assessed tax in dispute. For further information, please see Technical Information Release (TIR 11-6) regarding this issue.

The following examples demonstrate the use of Form A-32.

- A large multinational company with many state audits being conducted simultaneously mentions up front that it is going to have difficulty meeting record requests within certain time frames. Rather than being held to rigid time lines to ensure that the audit is completed within 8 months of the opening conference, the taxpayer opts to waive its right to a reduced interest rate to allow additional time to respond to information requests. In this situation, the DOR and the taxpayer may agree to waive G.L. c. 62C, § 32(f).
- In some instances, the taxpayer may not wish to waive its entire right to an interest reduction under G.L. c. 62C, § 32(f). Although the taxpayer may not wish to waive its rights under G.L. c. 62C, § 32(f), it may not be able to comply with substantial promptness and completeness to a particular request. For example, a taxpayer installs a new accounting software system and has to devote substantial efforts to the implementation of the new system. During implementation, the taxpayer will not be able to respond to information requests in a timely fashion. In this situation, the DOR and the taxpayer may agree to toll G.L. c. 62C, § 32(f) for a set period, such as an additional 3 month time period. If an additional 3 month waiver is signed the reduced interest rate will not be applicable until the 21st month or 39th month as the case may be.

While the DOR and the taxpayer might agree to waive or toll G.L. c. 62C, § 32(f), the field audit staff, including the auditor, supervisor and/or manager, must do their best to ensure the audit progresses in the most efficient manner. The signing of Form A-32 does not excuse the auditor from timely case completion. As with other extensions of the statute, the supervisors and managers must be informed prior to securing Form A- 32.

In addition, the securing of a Form A-32 does not relieve the auditor from monitoring and protecting the statute of limitations under G.L. c. 62C, §26. To protect the statute under §26 the Department and the Taxpayer can agree to extend the statute of limitations under §27 by executing a Consent Extending the Time for Assessment of Taxes. (See Form A-37 or B-37). Please refer to Chapter 1 of this manual for more information.

### **NonFiler Inquiry and Procedure**

During the conduct of the audit, the auditor must determine and resolve whether the taxpayer has failed to file a return, report of federal change or register with the Department for any tax for which it has a filing requirement.

The auditor must also consider and decide if a return is required to be filed by any out- of-state third party engaged in activities or transactions with the taxpayer. Upon determining that an activity or transaction may require the filing of a return with the Department, the auditor should discuss the matter with his/her supervisor who will either refer the matter to the Bureau of Desk Audit, Voluntary Disclosure/Nexus Unit, for issuance of the requisite nexus questionnaire or instruct the auditor to issue the nexus questionnaire if the non-filing taxpayer is located within the regional office's audit territory.

If it is determined that a taxpayer has failed to file a report of federal change to income, the auditor should incorporate the federal change into the audit deficiency rather than referring it to the Bureau of Desk Audit. The taxpayer may file a dispute online at [mass.gov/masstaxconnect](http://mass.gov/masstaxconnect). If the taxpayer is not required to file electronically or are otherwise unable to file a dispute online, file an abatement using [Form ABT](#). The auditor should instruct the taxpayer to file an Amended Return to report any change to income for any years not currently under audit.

The auditor or supervisor/manager should send an e-mail to the Federal Change Unit, Bureau of Desk Audit, to state that the federal change will be incorporated into the field audit. The auditor should enter a taxpayer "note" in the MASSTAX system with the same information including the tax years involved.

**The Notice of Failure to File a Return** (Form NFF/WebFile) and the **Notice of Failure to Register and File a Return** (Form NFR/WebFile) should be mailed to a taxpayer failing to comply with Massachusetts statutory filing requirements. The taxpayer must be allowed 30 days to comply before initiating assessment action.

The auditor should inform the taxpayer that new business or individual tax registrations must be completed through WebFile for Business (WFB). WebFile for Business (WFB), the DOR's web-based application, allows the taxpayer access to file and pay certain tax obligations. Additional information is provided in A Guide to WebFile for Business located on-line at [www.mass.gov/dor](http://www.mass.gov/dor).

### **Incorrect or Insufficient Return**

If, during the course of an audit, an auditor has reason to believe that a taxpayer has filed an incorrect or insufficient return based on a pattern of mis-reporting, he/she must discuss this matter with his/her supervisor and receive approval from the Director or Manager prior to issuing a Notice of Incorrect or Insufficient Return (Form NIR). The taxpayer has 30 days from the date of the notice to demonstrate the correctness of the original return or to file an amended return.

If taxpayer files an amended return in response to the notice, the auditor will determine the reasonableness of the return and decide if audit activity is warranted. The returns can be viewed through WebFile for Business and no longer require processing by the auditor.

If the taxpayer fails to respond to the notice within the time allowed, the auditor will complete the audit and initiate assessment action as provided under MGL, Chapter 62C, section 28. See the Notice of Incorrect or Insufficient Return (Form NIR).

## Chapter 5

# Audit Completion: Documentation of Findings and Administrative Remedies

### Introduction

Upon completion of the audit process and discussion of the audit results, the auditor and his/her supervisor or manager will confer with the taxpayer and/or designated representative at an exit conference. The auditor will prepare the electronic audit case folder to submit to his/her supervisor or manager for review including any audit adjustments prior to the exit conference. The conference is used to:

- Inform the taxpayer of audit results.
- Educate the taxpayer as to proper procedures to follow in the future.
- Explain the taxpayer's rights and available administrative remedies.
- Inform the taxpayer of penalty, interest and billing procedures.

### Discussing the Audit

The discussion of the audit will include:

- Any adjustments made are noted in accordance with the applicable laws or rulings involved. If not already given, then at this time copies of rulings and work papers that support the audit adjustments should be given to the taxpayer.
- The records used or examined and audit method employed. The reason for employing these methods will also be discussed.
- The mechanics of the audit, the basis of the audit assessment and how the assessment will be reflected on the proposed Notice of Intention to Assess (NIA). Included are any calculations, projections or other information detailed on the auditor's schedules. If not done already, then at this time the taxpayer will be given copies of all final audit schedules.

### Discussing Future Compliance

Promoting future tax compliance is one of the main goals of the Department of Revenue.

During an audit, the auditor has an opportunity and responsibility to help educate the taxpayer. The auditor can make recommendations on proper tax reporting methods; however, the auditor must not attempt to set up or redesign the taxpayer's accounting system.

The taxpayer should be aware that the tax law changes may impact business operations and that it is the taxpayer's responsibility to keep up-to-date with these changes. The Department publishes informational tax guides for mailings, provides taxpayer assistance on the proper tax treatment of specific transactions and maintains an updated legal library, which includes tax law changes, current rulings and regulations, technical information releases and directives that can be found at [www.mass.gov/dor](http://www.mass.gov/dor).

### **Audit Deficiency**

The taxpayer should be made aware that interest continues to accrue on any unpaid portion of a tax deficiency while administrative remedies are pursued.

### **Taxpayers Who Cannot Pay**

Auditors should advise taxpayers who cannot pay to discuss payment options with a representative from the Collections Bureau. Payment plans are outside the scope of the Audit Division and handled within the Taxpayer Service Division.

### **Collections Problems**

If the auditor believes that state funds are in jeopardy due to insolvency, a jeopardy assessment can be requested instead of a regular deficiency assessment. A jeopardy assessment will allow immediate notice and demand for payment rather than 30 days after the Notice of Intention to Assess. Approval by Directors and Chief of Bureau is needed for a jeopardy assessment to be issued. The auditor/examiner seeks approval through Audit WorkBench (AWB) by accessing Case Approvals and requesting Jeopardy Approval. Once final approval is granted, the case supervisor will access Interface Details to "Validate" and "Interface" the case which will issue the Jeopardy Assessment.

### **Credit Audits**

If at the end of an audit, there is an overall credit, the taxpayer will receive a refund.

The auditor will advise the taxpayer that:

- A refund will not be issued until all outstanding liabilities with the agency are satisfied.
- The total refund may be less than estimated if deficiencies occur for some other audit period in the audit.

The refund may be offset by penalties and interest associated with these deficiencies.

## **PENALTY WAIVER PROCEDURE**

**(Revised Jan-2015)**

### **Summary:**

Massachusetts General Laws provides for the imposition of penalties for the failure to comply with the tax laws of Massachusetts. They also permit the Commissioner of Revenue to waive or abate penalties in certain circumstances. The Audit Division is authorized to make penalty waiver determinations.

### **Imposition of Penalties, Generally:**

M.G.L. Chapter 62C, Section 33(a)-(c); (g) (Late File and Late Payment)

M.G.L. Chapter 62C, Section 28 (Double Assessment)

M.G.L. Chapter 62C, Section 34 (Information Returns-Partnerships)

M.G.L. Chapter 62C, Section 35 (Protested Checks); Sections 35A - 35E (failure to disclose; pay)

### **Authority to Waive Penalties:**

M.G.L. Chapter 62C, Section 33(f) and 35B,

Administrative Procedure 633 (AP633), and

DOR Directive 12-7

### **Background:**

Penalties may be waived if the taxpayer can support the contention that noncompliance was due to reasonable cause and not willful neglect. Determinations are based on particular facts and circumstances of each case. Criteria detailed in the Official Commonwealth of Massachusetts, Department of Revenue, MASSTAX Guide, Administrative Guide, AP633 and Directive 12-7 should be reviewed, conveyed to the taxpayer and used as a guide for determining an approval or denial of waiver of penalty requests as applicable.

Penalties may be abated only in circumstances where the taxpayer files returns through WFB/E-file during the course of the audit and submits a penalty waiver request. In these circumstances, the returns will post before the penalty waiver requested is acted upon thus creating an abatement situation. It is more efficient for the Audit Division to

act on any penalty forgiveness in such cases where the auditor/examiner is most familiar with taxpayer arguments and situations. Forms:

Waiver of Penalty Request Form

**Delegation of Authority:**

As follows, in accordance with the following delegation of authority table:

<u>Audit Division Personnel</u>	<u>Recommendation Authority</u>	<u>Approval Authority</u>
Auditor/Examiner/Supervisor/Manager	All Waivers	
<b>Regional Approving Tax Auditor II</b>		\$25,000 or less
Director		\$100,000 or less
Bureau Chief		\$250,000 or less
Assoc. Deputy Commissioner		\$500,000 or less
Deputy Commissioner		\$500,000 or less
Senior Deputy Commissioner		\$1,000,000 or less
Commissioner		\$1,000,001 or more

**PENALTY WAIVER PROCESSING PROCEDURES**

**General**

**The Regional Approving Tax Auditor II, Directors and/or Senior Managers within the chain of command will make the decision to waive or apply penalties up to their respective levels of authority.**

All penalty waiver requests will be handled through the Case Attributes node in Audit WorkBench (AWB). The auditor/examiner will enter the penalty waiver request amounts in the Case Attributes node and make his or her recommendation. The penalty waiver request form, all correspondence including the taxpayer’s penalty waiver request letter, and supporting documentation should be scanned and attached to the case in AWB-

Attachments and placed in the “All Administrative Forms” category. The request will be routed to the Regional/Unit Director or Tax Auditor II (TA-II) through the Case Approvals node for the initial approval or denial of penalties. All penalty waiver requests will be routed to the appropriate Senior Manager, as discussed below, when the request is greater than the Regional Approving Tax Auditor II’s or Director’s level of authority.

### **AWB - Case Attributes:**

AWB Penalty Waiver Screen Prints

### **Taxpayer Responsibilities**

- Submits a written request seeking penalties to be waived to auditor/examiner.

The letter must include a statement of fact supporting the contention that the noncompliance was due to reasonable cause and not willful neglect. The letter must be signed and dated by the taxpayer and/or a duly authorized representative.

### **Auditor/Examiner Responsibilities**

- Advises taxpayer of the administrative remedy, AP633 or Directive 12-7, Penalty Waiver process.
- Reviews taxpayer’s written penalty waiver request and any supporting documentation including taxpayer’s filing history.
- Scans and attaches the taxpayer’s penalty waiver request and any supporting documentation to the case in AWB-Attachments and places in the “All Administrative Forms” category.
- Reviews AP633 or Directive 12-7 for determination guidance.
- Makes recommendation with respect to any penalties that may be applicable.
- Completes penalty waiver request form, including the amount of calculated penalties, attaches the form to the case in AWB-Attachments, and places in the “All Administrative Forms” category.
- Enters penalty waiver amount requested and reasonable cause category, which best supports the taxpayer’s position, in the Case Attributes node.
- If necessary, includes additional comments, including multiple penalty waiver factors, to support the recommendation in the Attachments node and places in the “All Administrative Forms” category.
- Navigates to the Case Approvals node and selects new.
- Selects Penalty Waiver Approval or Penalty Waiver Denial and saves.
- Upon saving the request, AWB will route the request to the Regional Approving Tax Auditor II or Regional /Unit Director for approval or denial.

The supporting documentation scanned and attached to the AWB case should include the taxpayer's letter explaining the reason(s) that led to the delinquencies and/or manual penalties. This attachment should be placed in the "All Administrative Forms" category.

**Case processing responsibilities with regard to M.G.L. Chapter 62C, Sections 28, 34, 35 and 35A-E upon approval/denial of a penalty waiver request:**

- Advises taxpayer of DOR's determination via letter which is prepared by the appropriate audit personnel. If the request is denied and the taxpayer disagrees with the audit determination, the taxpayer may file a dispute online at [mass.gov/masstaxconnect](http://mass.gov/masstaxconnect). If the taxpayer is not required to file electronically or are otherwise unable to file a dispute online, file an abatement using [Form ABT](#).
- If approved, removes the Manual Penalty Type and Manual Penalty Amount from the tax period in AWB-Assessments.
- Enters appropriate note on MASSTAX regarding receipt of penalty waiver and determination.
- Requests or re-submits for Final Approval.

**Case processing responsibilities upon approval/denial of all other penalty waiver requests:**

- Advises taxpayer of DOR's determination via letter which is prepared by the appropriate audit personnel. If the request is denied and the taxpayer disagrees with the audit determination, the taxpayer may file a dispute online at [mass.gov/masstaxconnect](http://mass.gov/masstaxconnect). If the taxpayer is not required to file electronically or are otherwise unable to file a dispute online, file an abatement using [Form ABT](#).
- Please note that an automated selection report will be generated to individuals keying MASSTAX adjustments if an approval is processed.
- Forwards via an M-3210 Transmittal Form, any paper delinquent and/or amended tax return(s) to the DIB for posting of return.
- Enters appropriate note on MASSTAX regarding receipt of penalty waiver and determination.
- Final Approval of any case for which the penalty waiver has been approved should not be requested before you:
- Review the taxpayer's account on MASSTAX, if the late file and late pay penalties have been waived, to ensure that a reasonable cause (890) transaction posted to each tax period that the waiver is applicable to, and
- Review the Case Attributes node on AWB to verify that the MASSTAX Adjustment field has been set to Yes.

Field Audit Personnel should not work on their case until the MASSTAX Adjustment = Yes.

Note: If a penalty waiver is approved for NIA purposes only and we do not wish the 890 to post to the period(s) and waive the penalties for the original late filed return, then an email should be sent to the MASSTAX Representative to alert the representative to this fact. An accounting adjustment (775) transaction should be entered in the period(s) in these situations only.

### **Regional Approving Tax Auditor II Responsibilities (\$25,000 or less)**

Upon receipt of penalty waiver request for review through Case Approvals node:

- Reviews the taxpayer's letter, supporting documentation and the auditor's recommendation in Case Attributes.
- Determines if penalty should be waived or applied.
- If Approving Tax Auditor II changes the reasonable cause determination or denies the penalty waiver request, a statement should be supplied now to clarify why the reviewer made this determination. Additional comments to support the determination should be included via the Attachments node and placed in the "All Administrative Forms" category.
- Approving Tax Auditor II enters Penalty Waiver Approved Amount or Penalty Waiver Denied Amount in the Case Attributes node.
- If the penalty or penalties that are the subject of the waiver request are solely manual penalties or you are approving a denial request set the MASSTAX Adjustment field in the Case Attributes node to **Yes**.
- If you are waiving any amount of late file and late pay penalties (even if some manual penalties are also being waived) the MASSTAX Adjustment field must be left blank.
- After ensuring the Case Attributes node has properly been completed, you must select save.
- Navigates to the Case Approvals node and Approves or Rejects the recommendation made by the auditor, enters a note for the approval/rejection and saves.
- "Approved" penalty waivers generate a report for the MASSTAX Representative to post 890's if the MASSTAX Adjustment field is left blank. (Penalty Waiver denials are not processed on MASSTAX).
- If any manual penalties are waived the Regional Approving TA-II must ensure that the Manual Penalty Type and Manual Penalty Amount attributable to any waived penalty is removed from the appropriate tax period in the AWB-Assessments node.
- AWB - Messages alerts auditor/examiner that the penalty waiver request has been acted upon and receives an "Approval Approved" or "Approval Denied" message.
- Upon receiving "Approval Approved" message, the originating auditor/examiner completes required case processing responsibilities.
- Upon receiving "Approval Denied" message, the originating auditor/examiner should review instructions and make appropriate changes which may include resubmitting an Approval request.

## **Regional/Unit Director Responsibilities (\$100,000 or less)**

Upon receipt of penalty waiver request for review through Case Approvals node:

- Reviews the taxpayer's letter, supporting documentation and the auditor's recommendation in Case Attributes.
- Determines if penalty should be waived or applied.
- If Director changes the reasonable cause determination or denies the penalty waiver request, a statement should be supplied now to clarify why the reviewer made this determination. Additional comments to support the determination should be included via the Attachments node and placed in the "All Administrative Forms" category.
- Director or his/her designee enters Penalty Waiver Approved Amount or Penalty Waiver Denied Amount in the Case Attributes node and saves.
- "Approved" penalty waiver generates a report for the MASSTAX Representative to post 890's if the MASSTAX Adjustment field is left blank. (Penalty Waiver denials are not processed on MASSTAX).
- If the penalty or penalties that are the subject of the waiver request are solely manual penalties or you are approving a denial request ensure that the MASSTAX Adjustment field in the Case Attributes node is set to **Yes**.
- If you are waiving any amount of late file and late pay penalties (even if some manual penalties are also being waived) the MASSTAX Adjustment field must be left blank.
- After ensuring the Case Attributes node has been properly completed, you must select save.
- Navigates to the Case Approvals node and Approves or Rejects the recommendation made by the auditor, enters a note for the approval/rejection and saves.
- AWB - Messages alerts auditor/examiner that the penalty waiver request has been acted upon and receives an "Approval Approved" or "Approval Denied" message.
- Upon receiving "Approval Approved" message, auditor/examiner completes required case processing responsibilities.
- Upon receiving "Approval Denied" message, auditor/examiner should review instructions and make appropriate changes which may include resubmitting an Approval request.

## **Bureau Chief Responsibilities (\$250,000 or less)**

Upon receipt of penalty waiver request for review through Case Approvals node:

- Reviews the taxpayer’s letter, supporting documentation and the auditor’s recommendation in Case Attributes.
- Determines if penalty should be waived or applied.
- If Chief changes the reasonable cause determination or denies the penalty waiver request, a statement should be supplied now to clarify why the reviewer made this determination. Additional comments to support the determination should be included via the Attachments node and placed in the “All Administrative Forms” category.
- Chief or his/her designee enters Penalty Waiver Approved Amount or Penalty Waiver Denied Amount in the Case Attributes node and saves.
- If the penalty or penalties that are the subject of the waiver request are solely manual penalties or you are approving a denial request ensure that the MASSTAX Adjustment field in the Case Attributes node is set to **Yes**.
- If you are waiving any amount of late file and late pay penalties (even if some manual penalties are also being waived) the MASSTAX Adjustment field must be left blank.
- After ensuring the Case Attributes node has been properly completed, you must select save.
- Navigates to the Case Approvals node and Approves or Rejects the recommendation made by the auditor, enters a note for the approval/rejection and saves.
- “Approved” penalty waiver generates a report for the MASSTAX Representative to post 890’s if the MASSTAX Adjustment field is left blank. (Penalty Waiver denials are not processed on MASSTAX).
- AWB - Messages alerts auditor/examiner that the penalty waiver request has been acted upon and receives an “Approval Approved” or “Approval Denied” message.
- Upon receiving “Approval Approved” message, auditor/examiner completes required case processing responsibilities.
- Upon receiving “Approval Denied” message, auditor/examiner should review instructions and make appropriate changes which may include resubmitting an Approval request.

### **Audit Executive Responsibilities**

#### **Associate or Deputy Commissioner Responsibilities (same level of authority with \$500,000 or less)\***

Upon receipt of penalty waiver request for review through Case Approvals node:

- Reviews the taxpayer’s letter, supporting documentation and the auditor’s recommendation in Case Attributes.
- Determines if penalty should be waived or applied.

- If Associate or Deputy Commissioner changes the reasonable cause determination or denies the penalty waiver request, a statement should be supplied now to clarify why the reviewer made this determination. Additional comments to support the determination should be included via the Attachments node and placed in the “All Administrative Forms” category.
- Associate or Deputy Commissioner or his designee enters Penalty Waiver Approved Amount or Penalty Waiver Denied Amount in the Case Attributes node and saves.
- If the penalty or penalties that are the subject of the waiver request are solely manual penalties or you are approving a denial request ensure that the MASSTAX Adjustment field in the Case Attributes node is set to **Yes**.
- If you are waiving any amount of late file and late pay penalties (even if some manual penalties are also being waived) the MASSTAX Adjustment field must be left blank.
- After ensuring the Case Attributes Field has properly been completed, you must select save.
- Navigates to the Case Approvals node and Approves or Rejects the recommendation made by the auditor, enters a note for the approval/rejection and saves.
- “Approved” penalty waiver generates a report for the MASSTAX Representative to post 890’s if the MASSTAX Adjustment field is left blank. (Penalty Waiver denials are not processed on MASSTAX).
- AWB - Messages alerts auditor/examiner that the penalty waiver request has been acted upon and receives an “Approval Approved” or “Approval Denied” message.
- Upon receiving “Approval Approved” message, auditor/examiner completes required case processing responsibilities.
- Upon receiving “Approval Denied” message, auditor/examiner should review instructions and make appropriate changes which may include resubmitting an Approval request.

#### **Cases \$500,000 and greater:**

- Reviews the taxpayer’s letter, supporting documentation and the auditor’s recommendation in Case Attributes.
- Prepares an e-mail with penalty waiver recommendation and reason for such recommendation. Attach taxpayer’s letter, auditor’s recommendation, and other supporting documentation and forward to Senior Deputy Commissioner and/or Commissioner via e-mail.

#### **Commissioner’s Office**

### **Senior Deputy Commissioner/Commissioner Responsibilities**

- Reviews the taxpayer's letter, supporting documentation and the auditor's recommendation via e-mail.
- Determines if penalty should be waived or applied.
- Sends e-mail to Deputy or Associate Deputy Commissioner with determination.
- Deputy or Associate Deputy Commissioner makes the appropriate entries on AWB consistent with the Senior DC's or the Commissioner's determination.
- Deputy or Associate Deputy Commissioner forwards the Commissioner's Office determination to Bureau Chief.
- Chief or his/her designee ensures that the Senior DC's or the Commissioner's e-mail is attached to the case.
- Chief or his/her designee also double checks to ensure the Case Attributes node on AWB was properly completed.

### **MASSTAX Representative Responsibilities**

- Generates report for approved penalty waiver cases pertaining to late file and late pay penalties only.
- Keys 890 transactions in MASSTAX for approved tax period(s).
- Enters Audit WorkBench AWB-Case Log stating the 890 transactions were keyed to MASSTAX for the approved tax period(s).
- Navigates to the PW MASSTAX Adjustment field in AWB-Case Attributes and selects **Yes** from the drop down menu.

### **Supervisor Responsibilities**

- Final Approval request by your staff or Closure of any case should not occur until you:
- Review the taxpayer account on MASSTAX to ensure reasonable cause (890) transaction posted if late file and late penalties are being waived,
- Review the Case Attributes node to verify that the "MASSTAX Adjustment" field has been set to Yes for any approved waiver request, or
  - Verify the removal of the Manual Penalty Type and Manual Penalty Amount from the tax period in AWB-Assessments for any manual penalties that were waived.

### **Exit Conference**

Efforts are made to resolve any and all issues at the exit conference by the auditor's supervisor and/or manager. The taxpayer should be informed about the issues in dispute and that a Notice of Intention to Assess (NIA) will be issued in the near future.

Note: An exit conference does not constitute a hearing per MGL Chapter 62C,

section 26(b).

The exit conference procedures differ between the field audit bureaus within the Audit Division. Differences between the geography of the tax base, audit staff and the costs associated with travel both financial and time wise necessitate varying procedures.

### **New England Audit Bureau**

Within ten days from the date of the Exit Conference, if no additional documentation is requested, the audit supervisor and/or manager will provide the taxpayer with an Exit Conference Letter. If additional documentation is needed, the taxpayer will be requested to provide such documentation within a reasonable time frame. Within ten days upon receiving the additional documentation, the audit supervisor and/or manager will provide the taxpayer with an Exit Conference Letter. The Exit Conference Letter outlines the proposed audit adjustments and the taxpayer's appeal rights. It must also state that any requests for a pre-assessment conference and/or settlement consideration must be sent directly to the Audit Division within thirty days from the issuance of the NIA in accordance with AP 628.3.1. Included with the Exit Conference Letter will be the following Office of Appeals (OOA or Appeals) forms:

- Form DR-1, and
- Form B-37,

### **Multistate Audit Bureau**

Taxpayers are offered an exit conference initially by the audit manager through the issuance of the "10-day Letter". The "10-day Letter" is accompanied with the audit work papers which summarizes the audit issues and identifies the reasons for the audit adjustments. The exit conference can be conducted in person or via the telephone. Once the 10-day period has expired, an "Exit Conference Letter" is issued if there is a change due to an exit conference, additional information or the findings are sustained. The letter explains DOR's position as well as stating the NIA will be issued accordingly.

When additional information is not provided or conference held, the audit manager issues an "NIA Letter" advising the taxpayer that the NIA is being released.

Both the Exit Conference Letter and the NIA Letter will include the taxpayer's appeal rights. The letters must also state that any requests for a pre-assessment conference and/or settlement consideration must be sent directly to the Audit Division within thirty days from the issuance of the NIA in accordance with AP 628.3.1 and must include the above referenced forms DR-1 & B-37.

### **Documentation of The Audit Findings**

Completion of the audit process consists of compiling and documenting the information gathered during the audit and making any audit adjustments resulting from the exit conference. The electronic audit case folder should provide an audit trail that is easily understood by third party users such as attorneys, hearing officers and any others who may rely upon the audit in the future.

### **Audit Review**

The electronic audit case folder is a detailed record of the audit and contains reports, forms, schedules, documents and correspondence relating to the examination and results of a particular taxpayer.

All reports, forms, schedules, documents and correspondence detailing the audit scope and examination findings will be found in the electronic audit case folder. Navigating through Audit WorkBench (AWB)-Case Log, History and Attachments will provide access to all of the relevant case documentation and audit work papers.

Supervisory/management personnel are responsible for reviewing the completed electronic audit case folder in Audit WorkBench and approving auditor findings and conclusions through Audit WorkBench (AWB)-My Approvals prior to issuing a formal notice to the taxpayer. Any audit assessments resulting from the audit of the taxpayer's records will be entered into Audit WorkBench (AWB)-Assessments and will be interfaced with AAHT in the MASSTAX Declaration System which will generate the notice to the taxpayer.

The reviewer's responsibilities include:

- Surveying the electronic audit case folder for additional audit inquiry;
- Reading the auditor's report and understanding all audit findings and conclusions;
- Determining the proper application of statutes, regulations, policies and procedures by the auditor;
- Verifying the accuracy of arithmetic computations;
- Adhering to Audit/NIA approval procedures and securing authorization through Audit WorkBench (AWB)-Approvals for audit finalization in accordance with Audit Division guidelines;
- Ensuring that taxpayer notification procedures and processing of internal documents are timely initiated and completed in order to validate all aspects of the audit.

### **Internal Document Processing**

If, during the course of the audit, an auditor obtains delinquent/amended returns, tax payments, Taxpayer Registration Form TA-1 or any other taxpayer record, the original documents must be date stamped and submitted in a timely manner

to his/her supervisor or designee for processing. Copies of the original documents and transmittal forms are to be attached in the electronic audit case folder for supervisory information and review.

Note: Taxpayers should be utilizing the WebFile for Business (WFB) application to register for new tax types, additional tax types, file tax returns, make tax payments and make changes to any registration information online at [www.mass.gov/dor](http://www.mass.gov/dor).

Note: Checks should not be date stamped per bank requirements as of December 2003.

### **Taxpayer Notification**

The tax entered in the Audit WorkBench (AWB) will interface with AAHT in MASSTAX following review, approval and release by a supervisor, manager and/or director and be utilized to notify taxpayers of audit findings through the issuance of a Notice of Intention to Assess (NIA). (Auditors should refer to the Audit WorkBench Manual for the procedures to be utilized within AWB so the NIA will be generated and issued through the MASSTAX system.) Notice to taxpayers involving audits that result in a no change determination is to be given through the issuance of a No-Change Letter, which is found in Audit WorkBench-Notice Generation.

### **Contested Audits**

If a taxpayer disagrees with the audit results, the auditor should be certain that the taxpayer's objections and disagreements are understood and documented in the audit narrative attached to the case and recorded in the Audit WorkBench- Case Log. It is the responsibility of the auditor and/or supervisor to inform the taxpayers of the Office of Appeals (OOA or Appeals) process at the opening conference. Information pertaining to the process should be included in the audit contact letter and/or explained to the taxpayer at the opening conference. The Audit WorkBench (AWB)-Case Log should include an entry to indicate how/when the OOA procedures were explained to the taxpayer.

The three main reasons for disagreement are:

- Application of tax law;
- Audit procedures and methods; and
- The non-availability of records or documents.

A number of disagreed audits can be resolved before entering the appeal process.

- Disagreements concerning applications of tax law are generally harder to resolve prior to appeal because auditors have based decisions on

available research. The decisions are not likely to be changed prior to the appeal process since an auditor's supervisor and/or manager are limited to the same research material.

- Disagreements concerning audit procedures may be handled in the exit conference. These disagreements may be due to a lack of taxpayer input during the conduct of the audit or a lack of information shared with the taxpayer or the auditor. Through discussion at exit conferences, a better understanding of why certain audit procedures were used or why the audit procedures require modification may result.
- Disagreements concerning additional records or documentation are handled almost entirely through pre-appeal procedures. During the exit conference, the taxpayer is given time to produce additional information.

After the case has been reviewed and approved by the required supervisor/manager, the Exit Conference Letter will be sent to the taxpayer with Forms DR-1 and B-37 and the Notice of Intention to Assess (NIA) will be issued.

### **Appeal Procedures (Revised Aug-14)**

Following are the Audit Guidelines to be applied when a Taxpayer elects to appeal a proposed assessment.

#### **1. DURING THE AUDIT**

During the course of every audit, the Audit Division will ensure that Taxpayers are aware of their rights to dispute matters before the Office of Appeals (OOA) prior to assessment. There are various appeal options that are available to a Taxpayer before OOA:

- 1. Request a Conference**
- 2. Request Settlement Consideration**
  - a. Traditional Settlements**
  - b. Limited Information Settlements**
  - c. Expedited Settlements**
- 3. Request to Participate in Mediation (Mediation is generally available if the tax amount in dispute is more than \$250,000 and both the Department and the Taxpayer agree to participate).**

## **Conference and Settlement Consideration**

After an NIA has been issued a Taxpayer may request a conference or settlement consideration. If a Taxpayer elects to have a conference, OOA will schedule a conference with the Taxpayer. The conference is generally held by phone, but a Taxpayer may have a conference held in person. (A Taxpayer may also consider waiving its conference and just having its case decided on written submissions.) At the conference, OOA will go over the issue(s) in dispute, ask questions, and possibly request additional information. Based on the review of the file, the conference, and any additional information, OOA will issue a letter of determination on all of the issues that were the subject of the appeal.

A Taxpayer may also want to pursue settlement consideration. Sometimes answers to tax disputes are not always clear. In these instances, OOA has the authority to accept less than the full amount due considering the hazards of litigation. A Taxpayer or the Taxpayer's authorized representative may meet with OOA to discuss settlement options. If a Taxpayer elects both Settlement Consideration and a Conference, OOA will try to handle these matters simultaneously. For example, OOA would hold a conference regarding the matter in dispute but at the same conference it would also explore settlement options with the Taxpayer. If OOA could successfully negotiate a settlement, no letter of determination will be issued. However, if settlement failed OOA would then issue a letter of determination.

Recently, the Department initiated two new settlement options in an attempt to accelerate both the audit and appeals process; limited information settlements and expedited settlements.

### **Limited Information Settlements**

A Taxpayer that is unable to provide any additional documentation regarding the case may nonetheless wish to request settlement consideration. The Taxpayer may do so by completing a Form DR-1 and checking the box for limited information settlements. If accepted for settlement consideration, OOA will consider the case based solely on the information and documentation submitted to the Department through the date of filing the Form DR-1. In some instances, OOA may determine that the limited information settlement would not be appropriate for particular cases.

### **Expedited Settlements**

A Taxpayer may request that OOA consider reviewing a settlement proposal on an expedited basis by checking the appropriate box on Form DR-1. If a Taxpayer elects the expedited settlement option, the Taxpayer must submit a settlement proposal, a complete explanation of the facts and issues in dispute, provide all the necessary

documentation, and agree to participate in a hearing on an expedited basis. In addition, the person attending the hearing (whether it is the Taxpayer, an employee, or a representative) must have the authority to enter into a binding settlement agreement at such hearing. The Office of Appeals retains the discretion to determine that expedited settlement consideration would not be appropriate for specific cases.

## **Early Mediation Program**

### **Introduction**

The Early Mediation Program expands the range of dispute resolution options available to Taxpayers and, in appropriate cases, offers an expedited process, potentially avoiding time-consuming and expensive proceedings. The Early Mediation Program is a collaborative dispute resolution process for parties seeking resolution through reasonable compromise, and is designed to resolve all issues in a disputed matter. A representative of the Office of Appeals, serving as mediator, will assist the Audit Division and the Taxpayer in understanding and evaluating the issues in dispute to facilitate an expeditious resolution of the tax dispute consistent with applicable law. If the mediation is successful, the Department and the Taxpayer will enter into a settlement agreement.

Early Mediation is generally only available for cases in which the proposed tax amount in dispute is \$250,000 or more and both the Taxpayer and the Department agree to mediation. **A Taxpayer may not appeal the Audit Division's decision not to participate in the Early Mediation Program whether it's Pre or Post-NIA.** Early Mediation may be proposed by either the Audit Division or the Taxpayer when there are issues that cannot be resolved between the Taxpayer and the Audit Division alone. Early mediation may be raised prior to the issuance of the NIA, assuming all the facts are fully developed; however, a mediation request must be received no later than 30 days after the issuance of the NIA.

If mediation fails a Taxpayer will be afforded its normal appeal rights, such as a conference or settlement consideration. If the Taxpayer requested mediation post NIA and it fails, the Taxpayer's mediation request will be considered a conference request for purposes of meeting the required timelines for requesting a conference. See AP 635.

### **Opening Conference and/or Audit Contact Letter**

It is the responsibility of the auditor and/or supervisor to inform Taxpayers of the appeal process at the opening conference. Information pertaining to the appeal process should be included in the audit contact letter and/or explained to the Taxpayer at the opening conference. The audit log should include an entry to indicate how/when the OOA procedures were explained to the Taxpayer.

## **Desk Audits**

If correspondence is initiated prior to the issuance of a Notice of Intention to Assess (NIA), the Audit Process Notification Form, which includes information pertaining to the appeal process, should be sent to the Taxpayer.

## **Exit Conference**

When an exit conference is held the Taxpayer should be informed about the issues in dispute and that an NIA will be issued in the near future. After holding an exit conference, the Audit Division will issue an exit conference letter to the Taxpayer outlining the proposed audit adjustments and the Taxpayer's appeal rights. Included with every letter are a **Form DR-1** and **Form B-37** in accordance with AP 628.3.1. The exit conference letter should also clearly state that any request for a conference or settlement must be in writing and should be sent directly to the Audit Division.

As previously stated, the Taxpayer may opt to participate in the Early Mediation Program, but no later than 30 days after the issuance of the NIA.

## **Pre-NIA Appeals**

### **Filing an Application for Mediation Prior to Issuance of a Notice of Intent to Assess**

Upon reaching an agreement to participate in the Early Mediation process, prior to the issuance of a Notice of Intent to Assess by the Department, both the Taxpayer and a representative of the Audit Division will complete and submit a joint Application for Early Mediation Program to the Office of Appeals. In addition to the **Application for Early Mediation Program**, the Taxpayer must also complete and sign a Consent Extending the Time for Assessment of Taxes (Form A-37).

If the Taxpayer wishes to pursue mediation prior to the issuance of a Notice of Intent to Assess, the Taxpayer must sign a waiver tolling the time period for purposes of determining interest under G.L. c. 62C § 32(f). The period of time during which the

parties are participating in the Early Mediation Program will not be considered in determining the length of the audit for purposes of G.L. c. 62C, § 32 (f).

If the Audit Division determines that the matter is not appropriate for mediation, or if mediation fails, the Taxpayer may pursue the traditional appeals process.

### **Post-NIA Appeals**

#### **Request for Conference or Settlement with OOA**

The Taxpayer should be instructed to mail appeal request forms to the appropriate recipient in the Audit Division. To ensure the request is timely, it must be received within 30 days or postmarked within 25 days of the issuance of the Notice of Intent to Assess (NIA). See 830 CMR 62C.26.1(6)(d)2. The Taxpayer may also be asked or instructed to submit the required documents by electronic means such as fax or e-mail with the appropriate scanned items.

If the Taxpayer seeks additional time to review the NIA or attempt to resolve it at the Audit level and wishes to preserve its pre-assessment right to appeal it must, nonetheless, make a timely request for a conference/settlement. In such instances, an abbreviated written statement to that effect will be sufficient to preserve its timely appeal rights for up to an additional 30 days, subject to the approval of the Audit Bureau Chief or designee. If approved, the Audit Bureau Chief or designee must inform the OOA Director or designee within 3 business days of such request. If the Taxpayer decides to proceed with its request to receive a pre-assessment conference or settlement, a completed request (i.e., Forms DR-1 and B-37) should be submitted no later than the 60<sup>th</sup> day following the date of the NIA. If the Taxpayer decides not to proceed with its request to receive a pre-assessment conference or settlement, a written statement should be submitted withdrawing the request. Please note: The NIA should only be revised if adjustment is clearly warranted and the matter will not proceed to OOA for pre-assessment consideration.

#### **Limited Information Settlements**

In cases where the Taxpayer does not have or is otherwise unable to provide any additional information or documentation concerning the matter in dispute, the Taxpayer

may submit a settlement proposal and request OOA consider that proposal based solely on the information and/or documentation that has been submitted to the Department through the date of filing the Form DR-1.

The Office of Appeals retains the discretion to determine that limited information settlement consideration would not be appropriate for specific cases. Further, the limitation on factual development and/or the insufficiency of supporting documentation may be taken into account by OOA in the amount of any offer to which it might agree. A Taxpayer may request limited information settlement consideration by checking the appropriate box on Form DR-1.

### **Expedited Settlements**

A Taxpayer may request that OOA consider reviewing a settlement proposal on an expedited basis. A Taxpayer may request expedited settlement consideration by checking the appropriate box on Form DR-1.

The Office of Appeals retains the discretion to determine that expedited settlement consideration would not be appropriate for specific cases. To receive expedited settlement consideration, the following requirements must be met:

- a.** A complete explanation of the facts and issues in dispute must be submitted with Form DR-1;
- b.** A specific proposal for settlement must be submitted with Form DR-1;
- c.** All documentation necessary to support the settlement proposal must be submitted with Form DR-1;
- d.** For pre-assessment appeals, a completed Form B-37 must be submitted; and
- e.** The Taxpayer and/or the Taxpayer's representative must be prepared to participate in a conference on an expedited basis and must have binding authority to settle the dispute at the time of any conference or hearing.

\*In some instances a Taxpayer might not select the expedited settlement option when we otherwise believe that the case could be resolved in an expedited fashion. (For example, a Taxpayer previously settled a prior audit cycle that had exactly or almost exactly the same issue or issues that exist in the current audit cycle and we believe that the Taxpayer would just like to resolve the current case under similar terms as were negotiated in the prior cycle.) For cases like this, we should provide a statement in the

transmittal memo as well as add a note in the Appeal Note text box in AWB-Case Summary stating Audit is requesting that the case be resolved in an expedited manner. The statement and note should explain the reasons why we are requesting that the case be resolved in an expedited fashion.

### **Filing an Application for Mediation After the Issuance of a Notice of Intent to Assess**

In the event that a Notice of Intent to Assess has been issued, the Taxpayer may still seek mediation within a limited time period. In order to participate in the mediation program at this stage, the Taxpayer must submit an Application for Early Mediation within the same time frame as would be necessary to request a pre-assessment conference with the Office of Appeals. Accordingly, the Application for Early Mediation must be received within 30 days after the issuance of the Notice of Intent to Assess or postmarked by the twenty-fifth day following the issuance of the Notice of Intent to Assess. In addition to the Application for Early Mediation Program, the Taxpayer must also complete and sign a Special Consent Extending the Time for Assessment of Taxes (Form B-37).

If the Audit Division determines that the matter is not appropriate for mediation, the Taxpayer may pursue the traditional appeals process.

An Application for Early Mediation Program which is submitted after the issuance of a Notice of Intent to Assess will be deemed to be a conference request in accordance with G.L. c. 62C, § 26(b). If the parties either do not pursue mediation or do not resolve the matter through mediation, the Taxpayer will be afforded an opportunity for a conference with the Office of Appeals prior to assessment. The Taxpayer may also pursue settlement consideration with the Office of Appeals prior to assessment.

### **Submission and Notification of New Appeals**

#### **Mediation Requests**

If the Department agrees to mediate a matter with a Taxpayer, the case does not follow the traditional appeals route in AWB. Mediation cases are not transferred to OOA; rather Audit retains control of the case. OOA acts as the mediator between Audit and the Taxpayer. Consequently, the Appeal Start Date is not entered for mediation cases. (This is true even if the request is received post- NIA. If mediation fails post- NIA and the Taxpayer wishes to pursue the traditional appeal options, it is at that time the Appeal Start Date will be entered.)

An e-mail will also be sent to the Director of the Office of Appeals as well as the Chief of the Litigation Bureau. The e-mail will request that OOA assign a mediator to the case and that Litigation assign legal counsel to assist Audit with mediation. The e-mail should also include the completed Application for Mediation, any Taxpayer submissions, and our listing of issues that are subject to mediation.

If pre-NIA mediation is successful, please use the lump sum settlement procedures that follow for closing the case in AWB. If post-NIA mediation is successful, please use the post NIA settlement procedures that follow. If mediation is successful, pre or post-NIA, the mediation Case Flag must be changed from EMPPending to EMPSuccess. If mediation fails in either instance, the Case Flag must be changed to EMPFail. Then, click Save.

### **Conference and Settlement Requests**

Taxpayers are instructed to submit their request for appeals directly to the Audit Division. However, OOA will, within one (1) business day, inform the Audit Bureau Chief and designee via e-mail of appeal requests which Taxpayers mistakenly send to OOA. The e-mail will include a copy of the submitted Form DR-1. If the Taxpayer also submits a Form B-37 to OOA with its appeal request OOA will execute the Form B-37, if valid, and attach a copy of the executed Form B-37 to the AWB Case. OOA will also include a copy of the Form B-37 in the e-mail. If the Form B-37 is invalid/deficient in any manner, OOA will attach an unsigned copy of the Form B-37 to the AWB Case and forward the invalid/deficient form to Audit via e-mail. Audit will try to obtain a valid Form B-37 from the Taxpayer in this situation.

### **Non-AWB Case Files**

The applicable Audit Bureau will send an e-mail transmittal memo to the Director of OOA with copies to the Audit designee. For each non-AWB case, the memo will contain the following information:

- Taxpayer's name,
- Complete nine digit identification number
- MATIS#
- Tax type
- Tax periods
- Unit/Location Code
- Name of Audit contact person and phone number
- SOL date or date of execution of Form B-37
- Election to participate in conference
- Brief description of the appealed issues(s) and position(s)
- Paper file exists? Yes or No

- Bureau Chief, Director and Supervisor Name to clarify who should be contacted by OOA
- Taxpayer Contact (e.g., name and title)

The Audit Division will be responsible for ensuring that the NIA is put on hold. The Audit Division is responsible for entering the proper notifications on the MASSTAX system so that assessments are not made after the expiration of the relevant hold period. Audit will review the case to make certain that the case is placed into or still in NIA status "030". If the case has yet to be billed, but is in status "040", the supervisor or manager should take the case out of the billing process by putting it back in "030" status.

Audit will return a copy of the completed Form B-37 to the Taxpayer, maintain the original and insert a copy into the audit case file. A copy of the completed Form DR-1 will be kept in the case file and the original is sent to OOA. If the Form B-37 is not secured within thirty (30) days, Audit will verify the existing statute of limitations and note in the above e-mail that the Taxpayer was unwilling to execute a Form B-37.

#### **AWB Case Files**

If the Form B-37 is received, an authorized Audit manager will countersign the Form B- 37 submitted by the Taxpayer; scan and attach the copy of the Form B-37 into the AWB Case and return the copy of the executed Form B-37 to the Taxpayer.

For routine cases with properly submitted Forms DR-1 and B-37, Audit should enter the Appeal Date on AWB no later than five (5) days from the date of the written request for appeal. A note should be entered in the Appeal Notes text box of the Appeal section in the AWB-Summary stating that a transmittal memo is attached explaining the issue or issues being appealed. Note: The completed Form DR-1 and executed Form B-37 will be attached under the Office of Appeals category in AWB-Attachments. The transmittal memo should also be included in the Office of Appeals category in AWB-Attachments and should be labeled "Transmittal of Appeal".

An automated report will notify OOA and the Audit Division that an AWB Case is pending appeal when the Appeal Date is entered in Audit WorkBench (AWB).

If a Taxpayer submits a written request for appeal, but does not submit a Form B-37 or DR-1, an Appeal Date should still be entered within five (5) days of the written request (unless the Taxpayer has been granted additional time to resolve the disputed matter(s) -- see footnote 1 below). However, a note should be added to the Appeal Notes text box explaining that the DR-1 and B-37 have not been submitted and that Audit is attempting to secure both. The note should also explain if a transmittal memo is attached or when one will be attached. When the forms are secured, an appropriate note should be added to the Appeal Notes text box.

Generally, if a Form B-37 or DR-1 is not secured within thirty (30) days of the written request for appeal, Audit will verify the existing statute of limitations via the AWB system, and document in the Appeal Notes text box that the Taxpayer has failed to execute a Form B-37 and/or DR-1.

### **All Case Files**

For short statute cases (90 days or less remaining from the date the Taxpayer submits a written appeal on field audit and 45 days or less on desk audit) immediate e-mail notification should be made to OOA including the specific information listed in the Non- AWB Cases heading as well as the AWB Case ID.

### **AWB Appeals Process**

When a request for appeal is received in writing, the Audit Division will also be responsible for ensuring the NIA is put on hold. The Audit Division will be responsible for entering the proper conditions on the AWB system so that assessments are not made after the expiration of the relevant hold period. Upon receipt of a written appeal request, Audit will enter the following conditions into the AWB system<sup>1</sup>:

- Navigate to AWB-Assessments and click on the Interface Details link.
- Change the ITS Hold Type to Y-Hold NOA, the Update Code to 004-Appeal and the Reason Code to 010-Appeal.
- Change the AWB Status to 030-Hold NOA.
- Hit the “Validate “and “Interface” buttons to place a hold on the case.
- Navigate to AWB-Case Summary to Case Details and click on the Edit button and scroll down to the Appeal section. Note: Each bureau will select the auditor, supervisor or manager to update this section including the SOL per the Form B-37 and the Primary Case ID for Appeal.
- Check the Appeal box.
- Enter the Appeal Date using the calendar dropdown field. Note: The determination of the Appeal Date may vary among bureaus depending on what written request for hearing is received first. Regardless of which form is received, it is the date of the first written response that should determine the Appeal Date.
- Enter any notes in the Appeal Notes text box, especially notes that will be useful to OOA. Audit will include the Chief, Director, and Supervisor name directly in the text box to clarify who should be contacted by OOA. Audit will

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<sup>1</sup> For cases in which additional time has been granted to the taxpayer in an attempt to resolve the disputed matter(s), these conditions should be entered when the appeal request is completed, i.e., Forms DR-1 and B-37 are received. This requirement, of course, assumes the taxpayer wishes to proceed with its appeal rights. Generally, if the Forms DR-1 and B-37 are not received within 60 days of the NIA the conditions should be entered as soon as possible thereafter, but no later than 5 days beyond the agreed to due date.

also include the Taxpayer Contact (e.g., name and title). In addition, the following notes will be helpful: Form DR-1 is pending, a prior audit case with OOA results or attaching the OOA Transmittal Cover memo to the Office of Appeals category of the AWB-Attachments for the case. Note: Transmittal cover memos may be used for Field Audit cases and complex issues in the Bureau of Desk Audit (BODA).

- After filling in the above fields, click “Save”.
- Navigate to AWB-Period Details; click the Statute of Limitations tab and the Add SOL/Waiver button to update the SOL to 12/25/2027 if the Form B-37 is received. Note: In most cases, the SOL will be updated by the Audit Division when the Form B-37 is received. Note: OOA will have access to update the SOL *after* case assignment from the Appeals Selection Report by the OOA manager.

The screenshot shows a web form with the following fields:

- Appeal Date:** A dropdown menu with the date 6/4/2014 selected.
- Appeal Notes:** A text area containing the text "The taxpayer has requested a conference and settlement with the Office of Appeals." followed by a large black redaction box.
- Appeal Completed Date:** A dropdown menu with the date 6/5/2014 selected.
- Appeal Disposition:** An empty dropdown menu.

After clicking on the Save button, the information entered will be displayed in AWB- Case Summary in the Case Details section under the [View Notes](#) link.

The screenshot shows the "Case Summary for Case" interface with the following sections:

- Quick Search:** A search bar at the top.
- Primary Info:**
  - Case ID: [Redacted]
  - Case Type: SE&A Metro Region
  - Sub Type: Sales Tax
  - Case Status: Open
  - Details: [View...](#)
- Current Step: Creation Step**
  - Next Step: Audit Process
  - Next Step Date: 03/26/2017
  - Priority:
  - Work List:
- Primary User:** [Redacted]
- Case Amount:** \$0.00
- Period Begin:** [Redacted]
- Current SOL Date:** [Redacted]

**Case Details:**

- Home Phone:** [Redacted]
- Work Phone:** [Redacted]
- Address:** [Redacted]
- Created:** [Redacted]
- Case Source:** [Redacted]
- Last Contact:** [Redacted]
- Emp. Unit:** [Redacted]
- Start Date:** [Redacted]
- Department:** [Redacted]

**General Reason: 9 - RQ/CSA Selection**

- Specific Reason: 9072
- Continued Group: 9
- Parent Case:
- Parent Case ID:
- Case Flag:
- Case Source:
- Ref. ID Type:
- Ref. ID:

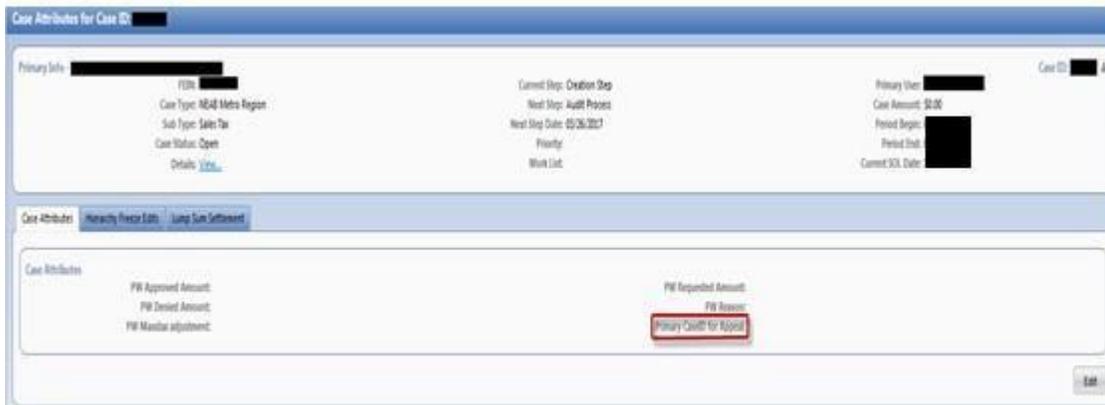
**Unit Status: 9**

- Unit Reason:
- Unit Exp:
- Appeal Date: 06/04/2014
- Appeal Notes: [View Notes](#)
- Appeal Contact: [Redacted]
- Appeal Status:
- Appeal Hook: 9
- FYAC: 9

Buttons: [Edit](#) [Close](#)

If two or more cases are related, that is the hearing for these cases should be held by the same Appeals Officer, a relationship must be established in AWB to link the cases together. This relationship is established by assigning the primary AWB Case number to the other related cases.

- Navigate to the AWB-Case Attributes.
- Enter the “primary” Case ID in each of the other cases that comprise the relationship.
- The new attribute called Primary Case ID for Appeal is found here in the red box.



See the examples below:

Example # 1 with two related cases:

Case 1000 is a meals tax audit of an S Corporation. The shareholder of the S Corporation has a case as well and the shareholder’s case is 998. Therefore, we have to relate case 998 to the primary case 1000.

Primary case:            1000

Secondary case:        998

The auditor, supervisor or manager will go to case 998, open the Case Attributes page and enter the Case ID “1000” in the case attribute named “Primary Case ID for Appeal”.

Example # 2 with four related cases:

Case 1000 is the principal reporting corporation. The other members participating in the combined return have cases and their numbers are 996, 997, and 998. Case 1000 is the primary.

Primary case: 1000

Secondary case: 996

Secondary case: 997

Secondary case: 998

The auditor, supervisor or manager will go to each of the cases 996, 997, and 998, open the Case Attributes page and enter the Case ID “1000” in the case attribute named “*Primary Case ID for Appeal*”.

## **2. AVAILABILITY OF THE CASE FILE FOR OOA**

Generally, once the Audit Division receives a new appeal all audit activity with respect to that case should cease and no adjustments may be made by Audit to the NIA. An exception, of course, is when the Taxpayer and Audit are attempting to resolve disputed matters during an extended NIA period. See – Request for Conference Section above.

At the time of NIA issuance, any case file should be complete in terms of content. The audit log, any narrative (except for certain BODA cases), and the exit conference letter should be included and up-to-date.

### **AWB Appeals Inventory**

The Office of Appeals manager can view newly appealed cases through a report found in the Selection node of the web based AWB application.

- Navigate to Revenue Premier (Portfolio Warehouse).
- Choose the Selection node.
- Choose the Appeals Reports.



- Open the Unassigned Appealed Cases selection view.
- Click, “Results”.
- Click, “Execute Custom” to view the most recent listing of appealed cases.

View Info: Unassigned Appealed Cases

View ID: [REDACTED]

Category: Appeals Reports

Valid Script: 0

Valid Custom SQL: 1

Unassigned Date:

Custom View:

Description: Unassigned Appeal Case not yet assigned to an ODA Office.

Team Case:

Access: Public, Protected

Owner: R22042

Last Generated On: 05/13/2014

Last Generated By: MCMR02

Case View Filter applied

Name	Category	Reported By	Reported Date	Assigned To	Unassigned Date
Completed Appealed Cases Not Interfaced	Appeals Reports	ACQ04080	05/10/2014	SMC14070	05/11/2014
2009 ODA Case	Appeals Reports	WRC08	08/08/2011	ROONEY	05/01/2014
USFCA ODA Case	Appeals Reports			ROONEY	05/01/2014
2010 ODA Case	Appeals Reports	201002	05/01/2013	ROONEY	05/01/2014
Unassigned Appealed Case	Appeals Reports	MCMR02	05/13/2014	SMC14070	05/13/2014

Change Options

After a few seconds, AWB will display the list of appealed cases. See below.

**Selection Result Details**

Unassigned Appealed Cases Result Details (#692000)- UnLocked

Selection Code Options

Selection Filter

Apply	Case ID	Updated By	Selection Codes	CASE_ID	BUREAU	LOC
<input type="checkbox"/>	[REDACTED]	MORRISD		[REDACTED]	BODA	FP
<input type="checkbox"/>	[REDACTED]	MORRISD		[REDACTED]	BODA	VC
<input type="checkbox"/>	[REDACTED]	MORRISD		[REDACTED]	BODA	VB
<input type="checkbox"/>	[REDACTED]	MORRISD		[REDACTED]	BODA	VA

The Office of Appeals manager assigns appealed cases in AWB to Appeals Officers using the “Unassigned Appealed Cases Result Detail”.

- Click, “Apply” next to the blue Case ID link.
- Click, “User Assignments”, an icon which will take you to the “Case Assignments” page. See below.
- Click, “Assign New User”. See below.
- Select the Appeals Officer’s User ID from the drop down menu.
- Click, “Assign”.
- Select the newly assigned Appeals Officer.
- Click, “Modify User Role”.
- Select new User Role of OOAOfficer. See below.

Primary Info

SSN: [REDACTED] Case ID: [REDACTED]

Case Type: BODIA Retained Revenue Primary User: Kathleen Feeney

Sub Type: Employee Business Expense R Case Amount: \$0.00

Case Status: Open Next Step Date: 12/15/2016 Period Begin: [REDACTED]

Details: [Link] Priority: Work List: Current SCL Date: [REDACTED]

Assigned Users

User	User's Role	Date Assigned	Phone Number	Phone Ext.	Case Downloaded
[REDACTED]	Primary	12/17/2013	[REDACTED]		N

User Information

User: Kathleen Feeney Phone: [REDACTED]

Role: Primary Extension: [REDACTED]

Date Assigned: 12/17/2013 Fax: [REDACTED]

Office Code: AGG0 Office Location: 200 Arlington Street, Room 4300  
Chelsea, MA 02135

Assign New User Assign User Modify User Role

**Primary Info** [Redacted] Case ID: [Redacted]

Case Type: SOCA Retained Revenue  
 Sub Type: Employee Business Expense R  
 Case Status: Open  
 Details: [View...](#)

Current Step: Creation Step  
 Next Step: Audit Process  
 Next Step Date: 12/15/2016  
 Priority:  
 Work List

Primary User: Kathleen Feeney  
 Case Amount: \$0.00  
 Period Begin: [Redacted]  
 Period End:  
 Current SOL Date: [Redacted]

---

**Assign New User**

User: Pac, Lori (336) [v]

Notes: [Text Area]

[Spell Check]

[Assign] [Cancel]

**Primary Info** [Redacted] Case ID: [Redacted]

Case Type: SOCA Retained Revenue  
 Sub Type: Employee Business Expense R  
 Case Status: Open  
 Details: [View...](#)

Current Step: Creation Step  
 Next Step: Audit Process  
 Next Step Date: 12/15/2016  
 Priority:  
 Work List

Primary User: Kathleen Feeney  
 Case Amount: \$0.00  
 Period Begin: [Redacted]  
 Period End:  
 Current SOL Date: [Redacted]

---

**Assign New User**

User: Pac, Lori (336) [v]

Notes: [Text Area]

[Spell Check]

[Assign] [Cancel]

[Last Processed: 4/21/15](#)      [Priority:](#)      [Primary User: Kathleen Feeney](#)  
[Details: View...](#)      [Work List:](#)      [Current SOL Date: 04/15/2015](#)

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**Assigned Users**

User	User's Role	Date Assigned	Phone Number	Phone Ext.	Case Downloaded
Kathleen Feeney	Primary	12/17/2013	1817 887-6419		N
Lori Paci	Secondary	07/01/2014	1817 626-3883	63883	N

---

**User Information**

User: Lori Paci  
 Role: Secondary  
 Date Assigned: 07/01/2014

Phone: 1817 626-3883  
 Extension: 63883  
 Fax:  
 Office Code: CO  
 Office Location: [100 Cambridge Street](#)  
[Boston, MA 02114](#)

[Assign New User](#)    [Unassign User](#)    [Modify User Role](#)

Case Status: **Open**      Priority:      Current SOL Date: 04/15/2015  
 Details: [View...](#)      Work List:

**Assigned Users**

User	User's Role	Date Assigned	Phone Number	Phone Ext.	Case Downloaded
[REDACTED]	Primary	12/17/2013	[REDACTED]	[REDACTED]	N
[REDACTED]	Secondary	07/01/2014	[REDACTED]	[REDACTED]	N

**User Information**

User: Lori Paci  
 Role: Secondary  
 Date Assigned: 07/01/2014

Phone: [REDACTED]  
 Extension: 63883  
 Fax:  
 Office Code: CO  
 Office Location: [100 Cambridge Street](#)  
[Boston, MA 02114](#)

[Assign New User](#)   [Unassign User](#)   [Modify User Role](#)

Sub Type: **Employee Business Expense R**      Next Step Date: 12/15/2016      Period Begin: [REDACTED]  
 Case Status: **Open**      Priority:      Period End: [REDACTED]  
 Details: [View...](#)      Work List:      Current SOL Date: [REDACTED]

**Assigned Users**

User	User's Role	Date Assigned	Phone Number	Phone Ext.	Case Downloaded
[REDACTED]	OOAOfficer	07/01/2014	[REDACTED]	[REDACTED]	N
[REDACTED]	Primary	12/17/2013	[REDACTED]	[REDACTED]	N

**User Information**

User: Lori Paci  
 Role: OOAOfficer  
 Date Assigned: 07/01/2014

Phone: [REDACTED]  
 Extension: 63883  
 Fax:  
 Office Code: CO  
 Office Location: [100 Cambridge Street](#)  
[Boston, MA 02114](#)

[Assign New User](#)   [Unassign User](#)   [Modify U](#)

## MASSTAX Notes

It is the responsibility of the auditor/supervisor to ensure that a case "Note" is put on MASSTAX to indicate that the case is at OOA. The "Note" should be entered on MASSTAX within five (5) business days of receiving the Taxpayer's written request. The information for the note should include the auditor's name and phone number, the tax type and tax periods involved.

## Attendance at Conferences

Attendance at conferences (either in person or via phone) is encouraged. Audit should note in the transmittal memo attached to the case if Audit would like to participate in the hearing. The Appeals Officer will send copies of the scheduling letters to the Audit personnel identified in the Appeal Notes text box.

## **Dispute of issues and submission of new information**

If Audit elects to comment on issues raised in the Taxpayer's Form DR-1, it will generally do so at the time the file is made available to OOA. In those situations where new issues or information are raised for the first time on the Form DR-1, and circumstances do not allow sufficient time to properly address the matter prior to referral, Audit may submit comments on those matters after the case file has been transferred to OOA. Any such comments should be submitted to OOA at least ten (10) days prior to the conference date. Audit will attach any such comments to the AWB file. When Audit attaches subsequent comments to the AWB file, it will trigger a notification e-mail to the Outlook account of the Appeals Officer.

During the course of an appeal, a Taxpayer may submit, on its own initiative or at the request of OOA, information not previously possessed by the Department. OOA will forward the documentation secured to the Audit Supervisor in the New England Audit Bureau and the Filing Enforcement Bureau, the Audit Examiner in the Bureau of Desk Audit and the Audit Manager in the Multistate Audit Bureau.

Any correspondence received by OOA, which is addressed or cc-ed to the Audit Manager, should, in fact, be transmitted to the addressee via e-mail, and not solely attached to the AWB file. All notification correspondence sent by OOA should reference the AWB Case ID.

OOA will scan and attach any new information to the AWB case and will ask Audit to review any significant new information.<sup>2</sup> Audit should review the new information and get back to OOA within a reasonable time frame. If the review is going to take longer than ten (10) business days, Audit should notify OOA to let them know when the review will be completed.

In addition, an AWB enhancement was implemented which will generate an automated outlook e-mail notification to the Primary Auditor, Supervisor, and Manager/Director, once a document (Attachment) such as an LOD, Settlement Agreement is attached to the AWB Case or a Case Log entry is added by OOA personnel.

## **3. FINAL DISPOSITION BY THE OFFICE OF APPEALS OOA**

### **Processing of AWB Case Files**

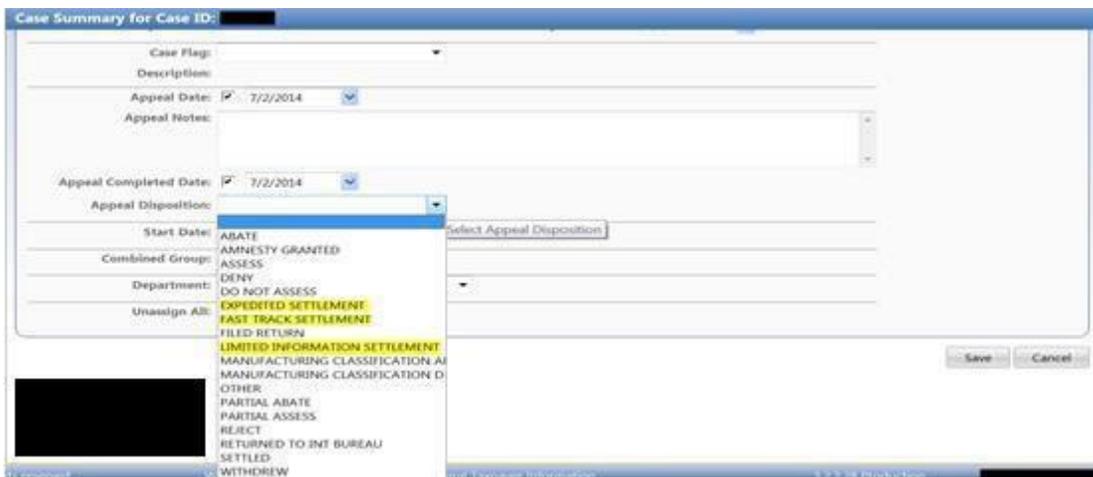
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<sup>2</sup> OOA will scan up to twenty (20) pages of taxpayer documents. If the taxpayer submits voluminous records, Appeals will forward the paper documents to Audit.

During the appeals process and upon resolution by OOA, the Appeals Officer has the ability to access the AWB Case in his/her “Inventory” to document the appeals process. The Office of Appeals should perform the following steps to document and complete the appeals process:

- Navigate to AWB - Summary and click edit and scroll down to the Appeal section.
- Attach Appeal documents including the Letter of Determination, Settlement Agreement, Rejection Letter and Withdrawal to the Office of Appeals category of the AWB-Attachments for the case as well as all “new documentation” received by OOA in the appeal process.
- Copies of all final actions regarding the AWB Case completed by OOA, such as Letters of Determination, Settlement Agreements, Rejection Letters and Withdrawals will be sent to the Chiefs, Directors, Supervisors and Primary Users (Auditor and Examiners) via e-mail.
- Upon case resolution by OOA, check the Appeal Completed box.
- Enter the Appeal Complete Date based on the date of the Letter of Determination and/or Settlement Agreement using the drop down field.
- Select the appropriate Disposition Code using the Appeal Disposition drop down field.
- Click, “Save”.

With the implementation of additional Settlement types, OOA will be able to select these specific settlement options: Limited Information or Expedited from the Appeal Disposition drop down, if necessary.



- The Office of Appeals will populate the Appeal Completed Date which will trigger the SOL edit. The SOL date will adjust to ninety (90) days after the Appeal Completed Date **or** the “original” SOL date, whichever is later. Note:

This adjustment will occur on the day after the Appeal Completed Date is entered.

- The case now appears on the AWB Report of Completed Appealed Cases.
- These actions by OOA prompt the case completed notification through AWB-Messages.

### OOA Disposition of Abatement Claims

OOA will send e-mail notification to the Bureau Chief of the initiating Audit Bureau for field cases only regarding the disposition of Abatement claims filed against field audit assessments. The e-mail notification should include the Letters of Determination, Settlement Agreements, Rejection Letters or Withdrawals.

### OOA Processing of Non-AWB Case Files

In cases where Settlement has been reached, OOA will send a copy of the executed Settlement Agreement, together with a cover memo, and any applicable settlement memorandum, to the Chief of the initiating bureau and the Deputy Commissioner's designee within five (5) business days.

In cases where a determination letter has been issued following a conference, OOA will send a copy of the determination letter and any applicable file memorandum to the Chief of the initiating bureau and the Deputy Commissioner's designee.

In cases where the request for pre-assessment settlement consideration has been rejected, or parties have been unable to reach settlement, and the Taxpayer did not request a conference, OOA will notify the Chief of the initiating bureau and the Deputy Commissioner's designee of the rejection. OOA will notify the Taxpayer that the appeal has been closed and that such constitutes the final disposition.

In all cases, the audit case file will be returned to the Chief of the initiating bureau within five (5) business days of appropriate Taxpayer correspondence.

The Audit Division should not infer from a settlement agreement that future cases would or should be settled on the same or similar terms with any Taxpayer, including the Taxpayer participating in settlement. Settlement agreements apply only to the tax years that were the subject of the audit and cannot be used by Taxpayers to affect the outcome of future audits unless specified in the settlement agreement. Language is included in settlement agreements to inform Taxpayers of this rule.

Note: Electronic versions of the Letter of Determination are preferred to expedite adjustments, if any.

### **Audit Processing of AWB Case Files**

Upon notification of the completed case by OOA, Audit should perform the following steps to process the appeal determination:

- Navigate to AWB-Assessments and make changes based on the results from OOA.
- Navigate to the AWB-Assessments: Audit Allocation link and select the Audit Issues tab to update the Issue Code, Issue Code Description and Assessment Value in the Edit Issues pane based on the determination from OOA, then click "Save".
- Navigate to the Interface Details and change the Update Code to 002-Corrected and the Reason Code should remain 010-Appeal, or in the case of negative tax periods, the Reason Code must be changed to 002-Negative Tax.
- Change the AWB Status to 020-Generate NIA & hit the "Validate" and "Interface" buttons to issue the revised NIA.
- For NOA purposes where negative tax periods exist, navigate to Interface Details and change the Reason Code to 010-Appeal to reflect the OOA results.
- Change the AWB Status to 040-Generate NOA & hit the "Validate" and "Interface" buttons to issue the NOA.

Upon notification of a Settlement by OOA, including Lump Sum Settlement, Limited Information Settlement, Expedited Settlement or Forward-looking Settlement, Audit should perform the following steps to process the appeal determination:

## Pre-NIA Lump Sum Settlements

In most cases, Pre-NIA settlements result from Early Mediation or forward-looking settlements and would be selected from the drop down based on the Settlement Type.

- Auditor/Examiner - Enters amount of tax in AWB-Assessments node based on settlement and/or Audit Work papers. This is done so the AWB Case routes correctly for AWB-Approval purposes based on the dollar amount entered in the Assessments Node. **Note: Do not create an NIA as no interface is required.**
- Auditor/Examiner - Enters details of EMP or Forward-looking Settlement in the AWB-Case Log, and Audit Narrative, if applicable.
- Manager/Supervisor - Selects the Lump Sum Settlement tab in AWB-Case Attributes.
- Manager/Supervisor - Click Edit. Selects the appropriate code (Pre-NIA) from the drop down.
- Manager/Supervisor - Allocates the appropriate amount of the Lump Sum Settlement to tax, penalty (including manual penalty), interest, Over Assessment, if any, and Collected Return Amount in AWB-Case Attributes Lump Sum Settlement tab.
- Manager/Supervisor - Verifies AWB-Case Attributes Lump Sum Settlement tab Total Field equals the settlement amount, excluding Collected Returns, if any. Click Save.
- Manager/Supervisor - Closes the AWB Case in AWB-Case Summary by selecting Lump Sum Settlement (LSS) from the drop down.

The screenshot displays the 'Case Attributes for Case ID: [redacted]' interface. The top section shows case details including 'Case Type: Multistate/Pittsburgh', 'Sub Type: Income', and 'Case Status: Case Reopened'. The 'Lump Sum Settlement' tab is selected, showing the following values:

Field	Value
Pay/Paid NIA - Pre-NIA	
Lump Sum Penalty	
Lump Sum Interest	\$2,500,000.00
Collected Return - Audit Tot	
Lump Sum Tax	\$3,490,000.00
Lump Sum Max. Penalty	
Over Assessment	
Lump Sum Total	\$4,990,000.00

## Post-NIA Lump Sum Settlements

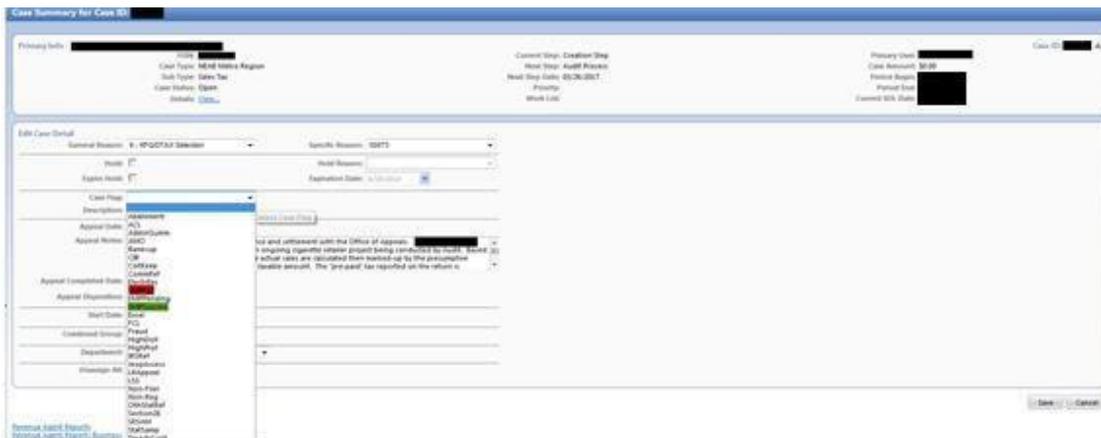
Post NIA settlements include Lump Sum Settlement, Limited Information Settlement, Expedited Settlement or post-NIA Mediation cases.

- Auditor/Examiner - Enters details of Lump Sum Settlement in the AWB-Case Log. It may also be entered into the Audit Narrative.
- Manager/Supervisor - Rejects the NIA in AWB (050 and Interface). **Note:** Please allow for the Return Interface in MASSTAX to occur prior to

- completing the process.
- Manager/Supervisor - Selects the Lump Sum Settlement tab in AWB-Case Attributes.
  - Manager/Supervisor - Click Edit. Selects the appropriate code (Post-NIA) from the drop down.
  - Manager/Supervisor - Allocates the appropriate amount of the Lump Sum Settlement to tax, penalty (including manual penalty), interest and Over Assessment, if any, and Collected Return Amount in AWB-Case Attributes Lump Sum Settlement tab.
  - Manager/Supervisor - Verifies AWB-Case Attributes Lump Sum Settlement tab Total Field equals the settlement amount, excluding Collected Returns, if any. Click Save.
  - Manager/Supervisor - Closes the AWB Case in AWB-Case Summary by selecting Lump Sum Settlement (LSS) from the drop down.



If the case was in mediations prior to closing the AWB Case, the Manager/Supervisor must ensure that the proper Early Mediation Case Flag has been entered. If successful, the Case Flag should reflect EMPSuccess and, if unsuccessful, the flag should reflect EMPFail.



## **MASSTAX Issues**

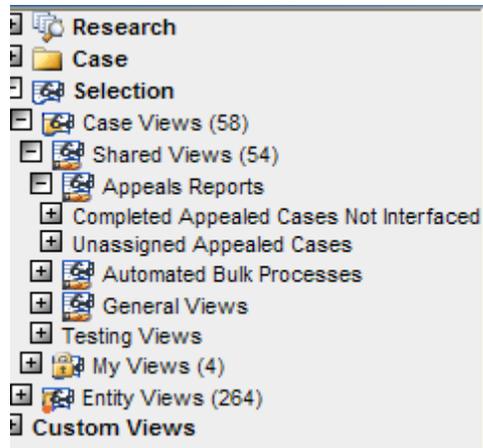
In both Pre and Post-NIA Lump Sum Settlements, certain steps must be followed to ensure the Settlement payment is received and posted correctly in MASSTAX.

- The Manager/Supervisor sends an e-mail to David Lee, Audit Division MASSTAX Liaison, stating the Department entered into a Settlement.
- The Manager/Supervisor submits the Taxpayer's Settlement check to the MASSTAX Liaison to post the payment to the audit period, unless an electronic payment was received. If an electronic payment was received, please forward all information with respect to the electronic payment to the MASSTAX Liaison for proper posting.
- The MASSTAX Liaison creates a dummy period within the audit. In other words, there will be no other period ending with that date so we will know it is a dummy period. All periods end on the last day of the month. This can be done for any tax type on MASSTAX. For example, if we have a monthly sales tax audit running from 1/08 through 12/10, a dummy period is created for one month within the audit period such as December 2010 with a month end of 12/30/10.
- The MASSTAX Liaison posts a 770 Transaction Code in the penalty column for the dummy period equal to the Lump Sum Settlement because interest will not accrue on a 770 penalty amount.
- The MASSTAX Liaison transfers the payment to the dummy period to zero out the period.
- The MASSTAX Liaison enters a "Taxpayer note" on MASSTAX explaining the transaction history in the dummy period for the Settlement.

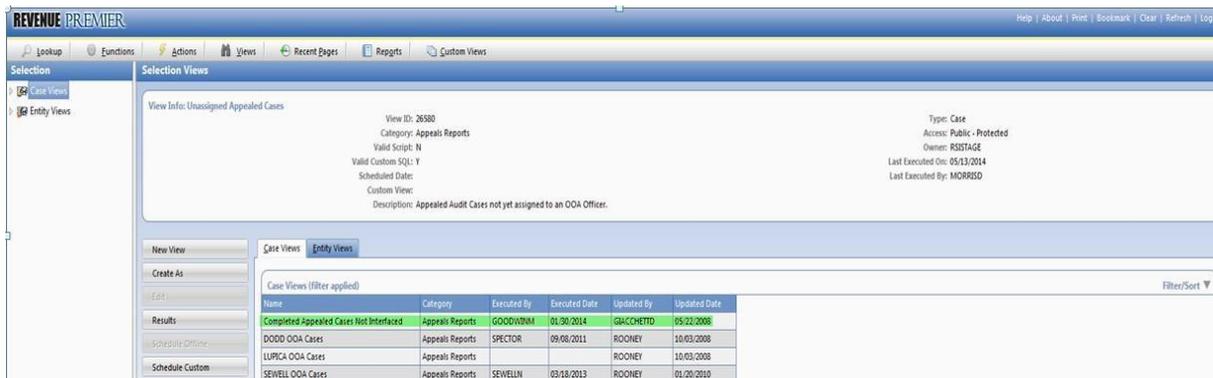
## **AWB Report**

The Audit manager or supervisor is able to run a report in AWB that lists the appealed cases for which the appeals process was completed as outlined below:

- Navigate to Revenue Premier (Portfolio Warehouse).
- Choose the Selection node.
- Choose the Appeals Reports.
- Execute the Completed Appealed Cases Not Interfaced.



- Click, “Execute Custom” to view the most recent listing of completed appealed cases, and cases which have not been re-interfaced to MASSTAX.



## Audit Processing Non-AWB Case Files

Upon receipt of the case file from OOA and related correspondence, the initiating bureau will ensure that MATIS is updated for the date the case was received from OOA and for the new statute of limitations date. Audit should perform the following steps to process the appeal determination:

- Make adjustments to NIA, if any, and issue revised NIA to the Taxpayer.
- Update all case files received from OOA for all correspondence, revisions and other documents prior to forwarding the closed case file to the Records Management Bureau.

- Close the MATIS case upon approval by the supervisor or manager when the NOA posts to the Taxpayer's account on MASSTAX.
- Include the updated penalty and interest amounts through the NOA date on the appropriate MATIS screen prior to closing.

## **Audit Referrals**

During the course of an audit, information on another taxpayer might be obtained and that warrants an audit referral.

Some examples of when audit referrals are to be initiated include:

- An investigation of a non-filer discloses that an audit is warranted;
- A taxpayer's business practices indicate the need of an audit to verify the accuracy and completeness of its tax reporting;
- An examination of purchases for use tax discloses that a seller is selling tax-free without the receipt of exemption or resale certificates;
- An examination of sales discloses that a customer is issuing invalid resale or exemption certificates; and/or
- An examination of the income apportionment formula discloses the taxable presence of a non-filing business.

The receiving unit must be able to evaluate the quality and merit of the referral to determine if the case is audit worthy and decide the assignment priority of an accepted referral.

The referral must include a narrative explanation as to why the case is being referred and how the referral was developed.

- In addition, the referral must be accompanied by all materials that document and support the referral such as copies of invoices and certificates (Form ST-4, ST-12, etc.). Any applicable tax returns already requested from the Records Management Bureau (RMB) together with a Form FR-1A - Transfer Sheet.

The Audit Referral Form, Form A-40C must be filled out completely and, if available, copies of contracts, certificates, audit schedules, invoices, newspaper articles or other pertinent data must be scanned and attached.

A sales tax auditor should state whether the items warranting referral were included in the audit of the taxpayer where the transaction was found.

## **Transmittal of the Completed Case Folder**

The completed case folder is sent to the Records Management Bureau (RMB)

within five days from the date of assessment with two copies of the Transmittal Form, Form M-3210. The Administrative Assistant or Director's/Manager's designee assigned these responsibilities retains the third copy of the Transmittal Form. The Administrative Assistant or Director's/Manager's designee receives and retains the signed acknowledgment copy of the Form M-3210 from Records Management in order to confirm receipt of the case by RMB.

Note: With the implementation of the electronic audit case folder through Audit WorkBench (AWB), paper case files will not be generated. As a result, there will be substantially less completed case folders to transfer to RMB as time passes.

### **Report of Change in Massachusetts Income**

Changes in Massachusetts income must be reported to the federal government in conformance with the Agreement on Coordination of Tax Administration between the Commonwealth of Massachusetts Department of Revenue and the Boston District of the Internal Revenue Service for personal income and corporate excise tax audits when increases in gross income or decreases in deductions result from the examination.

Each report must be completed in sufficient detail by disclosing: statutory authority; records and/or documents examined; other basis for auditor's findings, etc. This information is essential for the reviewer to determine the propriety of the adjustments.

All changes must be reported on Form A-SAR1. The **Form A-SAR1** must be completed in duplicate and included in the auditor's report when submitted to his/her supervisor. Upon review and acceptance by the supervisor, the Director will send the report through the Bureau Chief to the Federal/State Exchange Officer. The Federal/State Exchange Office will forward all Forms A-SAR1 to the Internal Revenue Service.

Whether the information is scanned depends on the volume of the documents. If the taxpayer submits voluminous records, Appeals will forward the paper documents to Audit.

## Chapter 6

### Specialized Audit Procedures

#### Application of Penalty - Chapter 62C, Section 35A

Section 35A states "there shall be added to the tax an amount equal to 20 per cent of the portion of the underpayment to which this section applies." Underpayment is defined as the amount by which any tax exceeds the amount shown as tax by the taxpayer on the return. The section 35A penalty applies when it is attributable to either one or both of the following: (1) negligence or disregard of the tax laws of the Commonwealth or of public written statements issued by the Commissioner; or (2) any substantial understatement of liability for a tax referred to in chapter 62C, section 2. (1)

The determination of whether negligence or disregard exists should be based on all of the relevant facts available. Section 35A(c) defines negligence as the failure to make a reasonable attempt to comply with the laws of the Commonwealth or public written statements issued by the Department. Disregard includes any careless, reckless, and/or intentional act to ignore the laws or public written statements. These determinations need to be made on a case by case basis based on a review of all the available facts, but this procedure provides some guidance in the application of this portion of section 35A.

The determination of whether a substantial underpayment exists is a mathematical calculation. Section 35A(c) states that a substantial understatement exists if the understatement for the period exceeds the greater of 10% of the tax required to be shown on the return for the period or \$1,000. (2) The statute provides further that for purposes of determining the applicability of and calculating the amount of the penalty, the understatement shall be reduced by any portion of the understatement which is attributable to (1) the tax treatment of any item by the taxpayer if there is or was substantial authority for the treatment; or (2) any item if the relevant facts affecting the treatment of the item are adequately disclosed in the return or in a statement attached to the return, and there is a reasonable basis for the tax treatment of the item by the taxpayer. However subparagraph (2) does not apply to any listed transaction or tax strategy as defined under chapter 62C, section 35B. (3) As provided in TIR 06-5 adequate disclosure may be made for any issue by emailing a written statement to **disclosure@dor.state.ma.us**. (4) Alternatively, for returns filed under c. 62 or c. 63, adequate disclosure can also be made on Form TDS. In considering whether there is "substantial authority" for a non-disclosed position or a "reasonable basis" for a disclosed ("non-tax shelter") position, auditors should interpret the term consistently with the use of the term in IRC Sec. 6662(d).

The section 35A penalty may also be waived for reasonable cause under section 35B. The Commissioner was granted the authority to issue regulations under section 35B to provide circumstances under which the section 35A penalty may be waived in the

interest of efficient administration of the tax laws of the Commonwealth. The Interest, Penalties and Application of Payments Regulation (830 CMR 62C.33.1) does not address the basis for waiver of section 35A penalties under this standard. However, we have developed the following procedures to assist in the determination of when to impose the section 35A penalty. We believe that these procedures further the intent of section 35B and provide for more efficient administration of our tax laws.

Therefore, in an effort to have more uniform application of the section 35A penalty the following procedures will be put in place:

First we must determine if an understatement on which a penalty may be calculated under section 35A exists. Therefore, we must determine the additional tax due for the period. From that we subtract the following amounts:

a. Any portion of the additional tax due that relates to a transaction for which there was substantial authority for the taxpayer's treatment of the item.

b. Any portion of the additional tax due that relates to a non-listed transaction that was adequately disclosed on the return, on Form TDS or in an email as provided in TIR 06-5 and there was a reasonable basis for such position.

c. In general any portion of the additional tax due that relates to income that was reported to a state and taxed at a substantially similar rate in such state. (For example a corporate taxpayer throws back sales to another state and as such the income was taxed in such state. We determine that all or a portion of those throw back sales should have been thrown back to Massachusetts. In this case the taxpayer paid tax to another state on such income and we will generally reduce the amount of understatement for the tax associated with this issue.) See the last paragraph of these guidelines, below, with respect to potential exceptions to these guidelines.

d. In general any portion of the additional tax due that relates to tax that a taxpayer voluntarily reports on an amended return without any contact from the Department. (If a taxpayer files an amended return after being contacted by the Department, the penalty may be assessed with respect to the amount of additional tax shown on the amended return as well as additional tax that might be assessed on an NIA. An NIA may be issued for the penalty at any time within the normal period for making an assessment. "Contact from the Department" should be construed broadly with respect to corporations that are part of controlled groups. Similarly shareholders in pass-through entities that are under audit may not be eligible for this relief with respect to items related to the pass-through entity.)

Any balance remaining due is the understatement for the period for purposes of section 35A. If this understatement is greater than 10% of the tax due for the period and \$1,000 then we have a substantial understatement for the period. When a substantial understatement exists we will generally propose the 20% penalty on the amount of the substantial understatement. However, the likely purpose of the section 35A penalty was not to raise revenue, but to foster compliance and preclude taxpayers from using

abusive transactions. In addition, section 35B contemplates that we must take into consideration the efficient administration of the tax laws before imposing the penalty. Considering these factors we will generally seek to impose the section 35A penalty for a substantial understatement where one or more of the following minimal criteria are met:

- a. A substantial understatement exists in 20% or more of the audit periods, or
- b. For the periods in which the substantial understatement exists, the tax (without regard to the other audit adjustments) was collected and not remitted, or
- c. The taxpayer's compliance history and internal controls have been determined to be inadequate, or
- d. The understatement relates to a recurring issue from a prior audit that was upheld or substantially upheld and the prior audit concluded before the period currently under audit began, or (5)
- e. Any subsequent situations in which by regulation, other public written statement, or internal procedures the Department determines that the section 35A penalty should be imposed.

If any of the above conditions are met we will impose the section 35A penalty on the substantial understatement. It may also be imposed in other cases as the facts may warrant.

The Section 35A Penalty Calculation Spreadsheet must be used by the auditors to determine if a section 35A penalty applies for a substantial understatement, and the amount of such penalty. In the first column the auditor enters the audit periods. In the next column the auditor enters the tax originally reported by the taxpayer. In the third column the auditor enters the additional tax due per audit as well as any additional tax filed with an amended return. In the fourth column (Adjustments to Understatement) the auditor enters any reductions to the understatement amount for the items discussed above, such as any additional tax voluntarily reported with an amended return and no contact from the Department. The spreadsheet will then calculate any penalties that are determined to be due for a substantial understatement. The auditor does not include this schedule with any preliminary workpapers provided to the taxpayer, but does attach it to the AWB case file. The auditor will review this schedule with his or supervisor/manager to determine whether the minimum criteria have been met. If the minimum criteria have not been met an audit log entry will be made stating such and, generally, that no penalty will be imposed. If one or more of the minimum criteria have been met, or a penalty is otherwise determined to be appropriate, the taxpayer should be informed that the penalty will be imposed. The penalty should now be reflected on the assessment summary workpapers provided to the taxpayer. The auditor must include an explanation in his or her narrative explaining that a penalty is being imposed under section 35A for a substantial understatement. This should also be explained to the taxpayer in the 10 day letter or the exit conference letter.

At times a substantial understatement may not exist, but we may nonetheless assess the section 35A penalty for negligence or disregard of the tax laws of the Commonwealth or public written statements issued by the Commissioner. The determination of when negligence or disregard exists is to be made on a case by case basis: however, we believe the following should be used as a guide in determining when to impose the negligence or disregard portions of section 35A.

a. When the underpayment is less than \$1,000, but is greater than or equal to 100% of the tax reported we may impose the section 35A penalty for negligence or disregard. Beyond just meeting this mathematical calculation there must be other factors that show that the taxpayer was negligent or disregarded the tax laws of the Commonwealth. (For example we have a cigarette retailer's purchase information. The retailer only reports a minimal amount of sales, which results in \$50 or \$100 of tax per month. Our review of its purchases show that the retailer should have been filing \$500 per month in tax.

In this situation negligence or disregard exists. The taxpayer knew that its sales were taxable as evidenced by its prior filings. The taxpayer just neglected to report all its sales. The penalty will be imposed in this situation.)

b. When the underpayment is less than 10%, but greater than \$1,000 the penalty may be imposed if we can show that negligence or disregard existed. Here we must show that the taxpayer either was negligent or carelessly, recklessly or intentionally failed to comply with the Commonwealth's tax laws or public written statements issued by the Commissioner. (For example a corporate taxpayer is paying intercompany royalties and/or interest to a related affiliate. The corporate taxpayer does not file a schedule ABI or ABIE and does not complete the relevant lines of the schedule E of the tax return. Consequently, the corporate taxpayer deducts the inter-company interest and/or royalties. We audit the return and determine that the corporate taxpayer is not entitled to the deduction. Our proposed assessment amounts to \$50,000 for the year, but it is still less than 10% of the overall tax originally reported. In this circumstance we will impose the penalty because the taxpayer failed to comply with the statute, public written statements, and the tax forms.)

c. Any other situation in which the facts clearly establish that the taxpayer either was negligent or recklessly, carelessly or intentionally disregarded such tax laws or public written statements and that the penalty applies.

Before proposing a section 35A penalty for negligence or disregard the auditor must discuss the matter with his or her supervisor/manager. If the supervisor/manager agrees with the auditor, the auditor must include an explanation in the narrative stating the reasons why the section 35A penalty should be imposed for negligence or disregard.

The explanation should state all of the facts as to why the penalty should be imposed. (For BODA employees, if a narrative is not completed the explanation should be contained within the audit log.) The penalty should now be reflected on assessment summary workpapers provided to the taxpayer. This should also be explained to the taxpayer in the ten day letter or exit conference letter.

In any instance when a penalty is being proposed under Section 35A, the taxpayer will be notified (where practical, before the issuance of an NIA). The taxpayer should be informed of its rights to request a waiver of penalty even if the rights were previously explained to the taxpayer. If the waiver request is filed with Audit, it will be handled under existing procedures. Auditors considering such requests should refer to federal regulations and case law in addition to the Department's own procedures. (6)

These are general guidelines and require discretion in their implementation. The Audit Division reserves the right to amend or revise these guidelines and to impose or waive the penalties construed herein where circumstances require notwithstanding provisions to the contrary.

Footnotes:

(1) This would include chapters 62 through 65A, section 10 of chapter 121A, and section 21 of chapter 138.

(2) For this purpose, the tax required to be shown on the return is the correct tax for the tax period (excluding penalties). Both the understatement amount and the amount required to be shown on the return are calculated without reduction for taxes withheld or estimated tax payments.

(3) Currently the only transactions that are listed transactions are those that are defined by the IRS as listed transactions. However, the Department has reserved the right to apply the relevant penalties to additional abusive transactions or tax strategies. See TIR 06-5.

(4) The email disclosure may, but is not required to be, in the form of a properly completed federal Form 8275 or 8275R. TIR 06-5.

(5) This criterion will not be considered as having been met if the understatement relates to tax on an issue that is currently on appeal from a prior proposed assessment or assessment.

(6) The guidelines in AP 633, as currently published, are specific by the type of penalty however, part VI states that the standards for waiving or abating section 33 penalties may be applied to other penalties imposed under MGL Ch. 62C or 62B, where appropriate. AP 633 and section 35B both have a reasonable cause standard: however, the AP states there must be reasonable cause and not willful neglect whereas section 35B states there must be reasonable cause and the taxpayer must have acted in good faith. Thus, while similar it appears there is a less stringent burden on the taxpayer's behalf under section 35B. Lastly with respect to applying AP 633 a taxpayer should be able to rely on the advice of a tax professional to avoid this penalty only where it can be demonstrated that the tax professional had been furnished all necessary and relevant information and provided incorrect advice. Otherwise any taxpayer who had their return professionally prepared could claim an exception to the penalty under section 35A.

## **Disclosure**

Audit Division employees are entrusted with a variety of records and information either maintained by DOR or obtained during the audit process. Some of the information maintained by DOR is public and is made readily available to those who request it.

However, certain records including audit information are confidential, and we are legally bound to protect the taxpayer's right to privacy.

## **Public or Confidential**

### **Tax Information to be Treated as Confidential**

Employees may not browse, publish, divulge or make known, in any manner, except as provided or required by law, any tax return, information contained in any tax return or in any schedule, list or other statement designed to supplement or to become a part of a tax return. Employees also may not publish, divulge, disclose or make known in any manner or to any extent not authorized by law any information resulting from any examination or investigation or contained in any report, record or electronic data source, when the information concerns or relates to: trade secrets, processes, operations, style of work or apparatus, or to the identity, confidential statistical data, amount or source of any income, profits, losses, or expenditures of any person, firm, party, corporation or association. When a question arises as to whether an item of information may be disclosed, the employee shall discuss the facts with his/her bureau chief who will request an opinion from the Litigation Bureau, if needed.

## **Requests for Information**

All requests for public records should be directed to the Rulings and Regulations Bureau which shall determine whether the requested documents are public records in accordance with MGL, Chapter 4, section 7, cl. 26.

## **Information Safeguards**

The primary safeguard to be employed is common sense. In the area of confidential tax information, it is always best to err on the side of caution because the taxpayer's privacy, as well as stiff fines, dismissal and imprisonment are at stake.

Pursuant to recently-enacted state law (Chapter 93H - Security Breaches), DOR will be required to notify the Attorney General, Director of Consumer Affairs and the affected individual when there is an unauthorized acquisition or use of such individual's personal information (including name, social security number, driver's license number, and financial account number or credit card or debit card number, with or without any required passcode).

As you know, existing law and our own longstanding, strictly enforced policy prohibit DOR employees from "browsing" or accessing taxpayer or child support customer information without a legitimate business purpose on MASSTAX, COMETS or any

similar electronic or other database. As a DOR employee, you receive training and reminders about your obligations and the penalties, including suspension, employment termination and criminal prosecution for violation of these principles.

In addition to the penalties currently in place, DOR will now be required to provide written notification to the Attorney General, Director of Consumer Affairs and the affected individual when a DOR employee engages in any unauthorized "browsing" or access of an individual's personal information on MASSTAX, COMETS, Registry of Motor Vehicles database, or any other electronic or other database.

The following are rules to follow:

- If an employee of the taxpayer questions the auditor about a part of the audit not within his or her own operating duties, the auditor should decline to comment until cleared with the designated taxpayer contact.
- When in doubt, an auditor may require a written request before releasing information. However an auditor cannot require the requester to state a reason.
- If the auditor is not familiar with the requester through contact during an audit, steps need to be taken to ensure that the requester is entitled to the information. Steps may include:
  - If personally visited, a letter from the primary taxpayer contact or other identification.
  - If written request, verification that the return matches the taxpayer's address.

If, phone inquiry, questions to determine entitlement to information i.e., calling back after discussion with taxpayer's designated contact.

If after review of these materials and auditor still has doubts as to whether or not information should be released, the Manager/Director must be contacted.

### **Inadvertent Disclosure**

Confidentiality can be betrayed without intent through carelessness. Although unintentional, this disclosure is also very serious. To prevent inadvertent disclosure an auditor will take the following precautions:

- Locking desk overnight and not leaving confidential information displayed.
- Signing off computer terminals;
- Locking briefcases when unattended at audits; and
- Locking cars when they contain audit files or other sensitive information.

## **Examining Records**

Most taxpayers see audits as a normal business occurrence and are not concerned about possible disclosure of information seen or compiled. Yet some taxpayers are apprehensive. An auditor will examine records that include these sensitive areas:

- Customer listings
- Pricing policies/markup
- Employee pay
- Vendors
- Lawsuit information
- Financial condition

However, sensitive records that are necessary to conduct an audit cannot be withheld. Massachusetts General Laws, Chapter 62C, section 24 authorizes the Commissioner to examine books, records, papers and other data of any entity for the purpose of verifying any return filed with the Commonwealth.

If the taxpayer expresses concern, the auditor can reference Chapter 62C, section 21 and 830 CMR 62C.21.1, establishing the confidentiality of all information obtained during the course of an audit.

## **Removal of Records from Place of Business**

When it becomes necessary to remove records from a taxpayer's premises, or a taxpayer delivers records to the office, a Taxpayer Document Receipt Form must be issued.

The taxpayer receives the receipt when records are taken and signs it when the records are returned complete and intact. This information is confidential and appropriate safeguards should be taken.

## **Maintenance of Records by the Auditor**

Auditors should take extreme care in protecting taxpayer's records that are kept within their possession. This includes records taken from the taxpayer's premises, e.g. worksheets, invoices, summaries, etc. (see above) and records obtained from our own files, e.g. returns, old audit folder, etc.

At work, the auditor should always make sure that records are not left unattended and assessable to passersby. At an audit site the records, if not electronically stored, should be locked in a briefcase or taken with the auditor when he or she goes to lunch or takes breaks. If electronically stored, the auditor should log off the computer, and store the computer in a locked room or cabinet. In addition, diskettes should always be stored in a secure area. In the office, auditors should never leave taxpayer's records unattended

after the completion of a work day. All records should be locked in the auditor's workstation.

In transit, the auditor must never leave briefcases and laptops, containing taxpayer records unattended in their automobile and visible to passerby's. Briefcases and laptops should be locked in the trunk, or at a minimum stored within the car out of sight with the car doors locked. In the evening, auditors must bring all of the taxpayer's records into their house.

Satellite auditors, when not in their office at home, must always secure taxpayer's records in a locked file cabinet supplied by the Department.

### **IRS Documents**

When federal tax information (FTI) is needed, it should be requested from the taxpayer. If the taxpayer is unable or unwilling to provide the information, the Department can obtain it directly from the IRS through the Federal/State Exchange Office.

In a change of IRS policy, DOR can now enter FTI, in as much detail as you want, as a taxpayer "NOTE" of or case note "CSNT". Using the note and case note screens on MASSTAX allows transaction tracking to monitor the unauthorized access of FTI.

A request from the Manager/Director to the Bureau Chief will include:

- Taxpayer name;
- Federal Identification Number;
- Documents needed (accounting years ending xx-xx-xx);
- The reason information is needed;
- Specify whether a return or transcript is needed; and
- Other states' tax return information.

Due to disclosure rules, the IRS documents are retained in a secured area by the Federal/State Exchange Officer. An auditor may view this information and take notes, yet will not be able to make copies. These notes are as confidential as the documents that are their source.

Audit Division regional managers and/or directors are authorized to directly contact other states' disclosure officers in order to obtain state tax return information filed with that state and needed in connection with an audit.

### **Why Am I Being Audited?**

When conducting an audit due to a fraud investigation, customer complaint, ex-employee complaint, etc., the source of the referral must not be conveyed to the taxpayer. The name of an informant or the information provided must not be revealed.

An auditor will take safeguards to ensure this information does not become an issue by leaving this information in the office.

If an audit is generated through a referral (i.e., a transaction seen in another audit) it is best to follow the above procedures. However, if after review of the taxpayer's records, this transaction is not uncovered, it may be necessary for the effective administration of state taxes to reference this transaction after receiving approval from the Manager/Director.

### **Proprietary Software**

Although not confidential, the software licensed by the State cannot be copied to pass along to someone else. In addition, non-licensed software must not be used on State equipment.

Violations to State software licenses can expose both the State and the employee to litigation involving copyright law.

### **Administrative Summons**

An Administrative Summons is a statutory demand for taxpayer records and/or testimony, if a taxpayer refuses to comply voluntarily, and is issued pursuant to the authority vested in the Commissioner under MGL, Chapter 62C, section 70, Sample Form.

If an auditor encounters difficulty in obtaining books, records, documents or other information essential to the proper completion of the audit, the auditor should discuss the need to request the issuance of an Administrative Summons with his/her supervisor in order to compel the production of records and/or testimony.

All requests for the issuance of an Administrative Summons must be approved by the auditor's Chief of Bureau, who will forward the request to the Deputy Commissioner of the Division for drafting. The Request for Administrative Summons will be submitted to the Litigation Bureau of the Legal Division to prepare and to serve on the appropriate party. See the sample Request Form. If a taxpayer or other party fails to comply with the summons, the Chief of Bureau will request an enforcement of the summons by preparing a Request for Summons Enforcement Form. The Deputy Commissioner will approve and forward the request to the Litigation Bureau. A sample Request for Summons Enforcement Form.

### **Bankruptcy**

With fluctuating economic conditions, bankruptcy has become a significant topic in auditing. In this section, the types of bankruptcy are listed along with the events and audit guidelines to help the auditor understand how it relates to the audit.

## Administration of Bankruptcy Cases

The DOR's Litigation Bureau has a Bankruptcy Unit which is responsible for working exclusively with taxpayers who have filed bankruptcy.

Bankruptcy cases are started when a taxpayer such as an individual, husband and wife, corporation, partnership or other entity, files a bankruptcy petition with the federal Bankruptcy Court. The calendar date on which the bankruptcy petition is filed is known as the Petition Date.

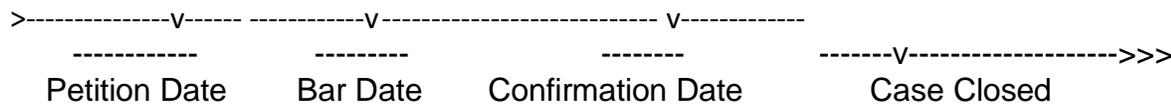
## Confidentiality

DOR staff must adhere to confidentiality restrictions and not discuss or reveal any confidential information regarding the bankruptcy case with any party other than the taxpayer.

## Bankruptcy Events

The following time line shows:

Typical timing requirements, but the sequence of events may vary:



1. Petition Date (Petition for bankruptcy filed) - case is begun by specifying the particular chapter under which relief is requested. May be voluntary (debtor files petition) or involuntary (creditor files the petition). The State is a secured priority creditor if liens have been filed prior to the filing of the petition. Otherwise, it is usually a priority creditor and is paid before the general unsecured creditors.

## Automatic Stay

When a taxpayer files the bankruptcy case, an automatic stay is placed into effect **immediately**, as of the hour and minute on the Petition Date, and prohibits all of the taxpayer's creditors, including the Department of Revenue, from taking any action to collect any debts or liabilities that relate to the time period before the Petition Date.

The Bankruptcy Court is authorized under federal law to impose damages for a willful and knowing violation of the automatic stay.

**Note: Damages can be awarded against DOR as well as its employees both personally and individually. It is extremely important that all DOR staff comply with the automatic stay.**

The following is a list of actions that are specifically prohibited by the imposition of the automatic stay:

- Contacting the taxpayer to request or demand payment;
- Sending notices of demand for payment;
- Recording liens or issuing levies;
- Proceeding with action to revoke a license; and
- Taking any other action whatsoever to collect any unpaid tax.

2. Bar Date or File - By Date (Proof of claim filing deadline) - the date by which a claim must be filed in order for the claim to be considered and for the creditor to be listed. In Chapter 7 and 13 cases this date is always 90 days after the first Section 341 meeting of creditors; in Chapter 11 cases, a bar date may be set by the court on motion of a party in interest (usually the debtor); the bankruptcy judge decides the actual date. **If the State does not file a proof of claim prior to the bar date, the State's claim for taxes in some instances may be discharged.** The proof of claim can be an estimate at the time of filing, and can be changed later to a more definite amount even after the Bar Date provided the final claim is for the same tax type(s) and same tax period(s).

3. Confirmation Date (Confirmation of plan/discharge) - the date at which the plan for reorganization and discharge of debts is accepted by the court. The Department may still be permitted to make an assessment of a discharged debt if the Department's purpose is to pursue a non-debtor party for the discharged debt. The discharge generally runs in favor of the debtor only, not a non-debtor party, as, e.g., a responsible person. If a taxpayer is bankrupt and did not file returns and remit tax collected, the taxes collected generally will not be discharged by the bankruptcy court unless the Chapter 11 or Chapter 13 reorganization plan allows for such a discharge.

4. Case closed.

#### **Audit Guidelines**

The following general guidelines should be followed to protect the State's interest:

- Review the MASSTAX inquiry screen TRBK, in all cases, to determine if the taxpayer's account indicates bankruptcy status.

Records to be requested:

- If the taxpayer is in bankruptcy, and is not reflected on MASSTAX Screen TRBK, ask for a copy of the Section 341 Notice or Petition for Bankruptcy and send to the Bankruptcy Unit.
- If the taxpayer states that his or her bankruptcy is near the confirmation date or a discharge, ask for a copy of the Notice of Discharge, the order confirming the Plan, the Plan itself, and forward to the Bankruptcy Unit.

- Review the MASSTAX Screen TRBK inquiry for information on the bankruptcy. (This inquiry may not be current due to the lapse of time between filing and the State's being notified.)
- The auditor should immediately contact and apprise the audit supervisor of the situation.
- The taxpayer's name, location of the Bankruptcy Court, the Bankruptcy Court docket number and the Petition Date should be obtained and forwarded to the Bankruptcy Unit if the taxpayer, taxpayer's representative or non-attorney representative informs DOR staff of the bankruptcy case.
- Contact the Bankruptcy Unit by telephone, email or fax. A bankruptcy examiner will work with the auditor to determine how the audit will proceed and the time frame within which the audit must be conducted. Do not hesitate to ask the Litigation Bureau for assistance at any time.
- These actions are specifically **not** prohibited by the imposition of the automatic stay:
  - The commencement, continuation, and conclusion of a tax audit;
  - The issuance of a tax deficiency (NIA);
  - A demand for tax returns;
  - The making of an assessment for any tax and issuance of a notice of demand for payment of such an assessment (NOA), which combines in one document the notice that the assessment has been made, which is required by MGL Chapter 62C, section 31, and a demand for payment.
- Any audits that are currently in progress on the Petition Date are **not** affected by the automatic stay and can proceed to assessment through the normal steps including conference and NIA, etc.;
- Any audit commencing after the Petition Date may include tax periods before or after the Petition Date, however, Audit Division staff **should** notify the Bankruptcy Unit of the existence of the audit, so an estimated proof of claim can be filed;
- MGL, Chapter 62C, section 26(b) specifically suspends the running of the three year period for making an assessment during the period of time that a taxpayer has a bankruptcy case pending under the appropriate chapters of Title 11 of the United States Code.
- When the audit is completed, Audit Division staff **should** inform the Bankruptcy Unit of the audit results so the proof of claim can be amended to represent the correct tax liability.

Note: Periods subject to audit should include those that occur within the three-year statute of limitations from the date the return was filed while the case is in bankruptcy.

- If a Chapter 11 taxpayer has a **confirmed** Plan of Reorganization, then only audit post confirmation periods. Remember that all pre-confirmation taxes are automatically discharged by the bankruptcy court order approving the Plan of Reorganization. Always check the MASSTAX taxpayer "NOTE" screen to see if a Chapter 11 case was filed and, if so, when the Plan of Reorganization was approved. Any tax credits and/or taxes due before that date are discharged and

cannot be audited, except as to Trust Fund taxes. See note at paragraph 3 under Bankruptcy Events. Also, in some limited situations, it is permissible for the Department to set off a discharged debt against a refund due for a pre-petition period.

- If the taxpayer has not yet filed for bankruptcy but is about to, or the auditor feels that the taxpayer has financial problems such that collection of taxes would be jeopardized, the auditor's supervisor should also determine whether the audit should be expedited so that a jeopardy determination can be issued. An immediate request for lien filing may be sent to the Collections Bureau.

Note: There are no set guidelines for determining when a jeopardy determination should be issued. The auditor should obtain as much financial information about the taxpayer as possible and discuss the situation with the supervisor and/or manager.

- Standard auditing and write-up procedures should be expedited on all bankruptcy audits. In some cases, figures may be phoned in to the Bankruptcy Unit for claim filing.
- Determine the final amount of the deficiency, both pre-petition and post-petition, prior to the confirmation of the plan. If possible, estimate the liability prior to the bar date and request that a claim be filed. The claim can be amended later when the actual amount is known. Notification of sampling procedures is required for all estimates.
- Consider a penalty waiver as usual.
- Redetermination requests will be the same as for all other taxpayers.
- Under **Section 505(b) of the Bankruptcy Code {11USCS.505(b)}**, a trustee (including presumably a debtor-in-possession) in a bankruptcy case may make a written request for a determination of any required liability of the bankruptcy estate for any tax incurred during the administration of the bankruptcy case. By making such a written request along with filing of a tax return for such tax and payment of the tax shown on the return, the trustee, the debtor and any successor to the debtor may obtain a discharge from any further liability for such tax if the Department does not notify the trustee within 60 days after such request, that this return(s) has been selected for audit or the Department fails to complete the audit and fails to notify the trustee of any tax due within 180 days after such written request by the trustee. Some courts have held that a taxing authority's failure to notify the trustee within 60 days of the written request and payment under this provision even results in a discharge of interest and penalties attributable solely to the trustee's late filing of the return and late payment of the tax. Consequently, if an auditor receives such a written request for a so-called "quickie audit", he/she should insure that all processes, including billing, are expedited so that the trustee receives notice from the Department within 60 days, and so that any resulting audit is completed within 180 days.
- The Bankruptcy Unit and attorneys from the Litigation Bureau are responsible for arranging payment of DOR's tax claim and for resolving or litigating any disputes regarding the legality or the amount of the tax claim.

- After the taxpayer's case is closed in federal Bankruptcy Court, the Bankruptcy Unit will list any unpaid tax claims that are not affected by the bankruptcy and will forward the case to the Collections Bureau the necessary action.

## **Types of Bankruptcy Chapter 7 –**

### **Liquidation**

- Available to:
  - Corporations
  - Partnerships
  - Individuals
- Provides that all or substantially all of the property be liquidated.
- Provides the individual a discharge of debts except for most taxes. Corporations and partnerships do not receive a discharge of debts.
- Corporations should be liquidated, dissolved and uncollectible.
- Upon filing of petition, business operations are to be terminated, unless, Chapter 7 trustee obtains specific order from Bankruptcy Court allowing him/her to operate business.

### **Chapter 9 – Municipalities**

- Available to governmental authorities.

### **Chapter 11 – Reorganization**

- Available to:
  - Corporations
  - Partnerships
  - Individuals
- Generally provides for a reorganization of the entity.
- Provides a discharge from pre-confirmation taxes (except for most taxes for individuals), including state taxes that are not included under their plan of reorganization.
- The debtor obtains relief from creditor harassment while staying in business; is allowed to file a plan of reorganization to implement a means of paying off his or her pre-petition and administrative expense debt. It should be emphasized, however, that post-petition taxes are required to be paid on an on-going basis.
- The debtor must remit all post-petition taxes.

### **Chapter 12**

- Available to family farmers with annual income. May include a corporation or partnership if over 50% of it is owned by farmers.

## Chapter 13 - Debt Adjustment

- Available to individuals with regular income only (includes a husband and wife). It may include a business operated as a sole proprietorship.
- Includes limit on debts (\$100,000 unsecured; \$350,000 secured debt). Under proposed legislation currently before congress, these limits will be raised.
- Provides a "super" discharge of all debts provided for by the plan upon completion by the debtor of all payments within three to five years (usually five).
- Provides a hardship discharge if debtor cannot, for reasons for which the debtor should not be held accountable, make payments under the plan. This hardship discharge does not apply to most taxes.
- Allows debtor to orderly pay off his or her debts without harassment from creditors.
- Allows debtor to pay off debts under a plan in small amounts for three to five years without interest.

### Large Corporations in Bankruptcy

If a large corporation files for a Chapter 11 Reorganization, perform an audit unless one was recently completed. Also, protective claims for corporation excise taxes should be filed for all pre-petition and post confirmation periods if Audit has reason to believe the IRS is or may be conducting an audit that may result in "**federal change**" liability. Any audit should be scheduled and conducted as soon as possible after filing. Ninety days after the bankruptcy is filed a bar date for claims may be set. Keep in very close contact with the Bankruptcy Unit and the Litigation Bureau to be sure that the claim based on the audit is timely filed with the court. If the taxpayer is uncooperative, the Bankruptcy Unit, through the Litigation Bureau, might want to submit a motion to the bankruptcy court for a turnover of the records or for an extension of time to file a claim.

Also, if necessary, an estimated audit should be performed and amended at a later date after discussion with the Bankruptcy Unit and the Litigation Bureau.

Income taxes withheld from employees and sales taxes collected prior to the bankruptcy filing are considered "trust fund" taxes. The court will be petitioned for immediate payment of these taxes.

### Insolvent Taxpayers

Insolvency is the inability to pay debts as they fall due in the usual course of business and/or having liabilities in excess of a reasonable market value of assets held, or insufficient assets to pay all debts.

A claim for insolvency should not be confused with imminent or actual bankruptcy. The insolvent taxpayer is either committed to paying his or her debts without seeking the legal relief available to the taxpayer in bankruptcy, or he or she is unable to afford legal fees to obtain protection under bankruptcy law. See the bankruptcy section of this chapter.

When insolvency is claimed, the Audit Division generally requires an examination of the records before making a recommendation. The Bureau Chief will issue a memo to the supervisor/manager requesting an insolvency investigation.

The investigation will verify the accuracy of the taxpayer's financial data by the given deadline and convey the findings to the Bureau Chief. The auditor's supervisor should also determine whether the audit should be expedited so that a jeopardy assessment can be issued. An immediate request for lien filing may be sent to the Collections Bureau.

Note: There are no set guidelines for determining when a jeopardy assessment should be issued. The auditor should obtain as much financial information about the taxpayer as possible and discuss the situation with the Supervisor/Manager or Director.

### **Sources of a Claim of Insolvency Audit in**

#### **Progress**

The auditor may detect an unstable financial condition. The auditor should consult with the case supervisor/manager in deciding whether or not to continue the audit. If it is decided to continue the audit, consideration is to be given to statutory deadlines, scope of audit and the potential for audit adjustment and subsequent collection of a deficiency assessment.

#### **Direct Contact**

The auditor should refer all taxpayers claiming insolvency to the Legal Division which will be primarily responsible for handling telephone and mail contact from taxpayers claiming insolvency outside of audits in progress.

### **Performance of the Review**

#### **Objectives**

Ascertain that the taxpayer's financial condition, as reflected on his books and records, has not been the result of intentional or not intentional falsified financial data. The major objectives for implementing a review include:

- Confirming balances of financial statements;
- Determining that the financial data submitted by the taxpayer is in accordance with GAAP and that usage is consistent;
- Confirming all transactions and balances as bona fide;
- Verifying the existence and ownership of all assets;
- Verifying that expenses and liabilities are not overstated; and
- Verifying that income and expenses are not understated.

In most instances, the taxpayer is a proprietorship, partnership and/or closely held corporation. The records maintained by these taxpayers often represent un-audited financial data. Scrutinize all audit evidence for reliability.

**Basic Plan**

The following outline is a basic plan in the overall examination of a taxpayer's books and records. Additional procedures unique to the specific audit and adapted to the size and nature of a taxpayer's business may be needed.

- Review the taxpayer's system of internal control.
- Analyze and review the general ledger.
  - Compare general ledger balances with financial statement balances.
  - Scan account entries.
  - Test account balances.
  - Trace postings from sub ledgers and general journal
- Analyze and review the subsidiary ledgers.
  - Obtain trial balances of asset accounts.
  - Foot trial balances and compare to controlling accounts.
  - Compare trial balance of Accounts Receivable with individual account balances in the subsidiary ledger.
- Examine books of original entry.
- Obtain external evidence if necessary.
  - Confirm accounts receivable.
  - Confirm bank accounts.
  - Inspect inventory.
  - Inspect other assets.
- Make overall inquiries of accounting policies.
  - Depreciation policy.
  - Credit policy.
  - Basis of accounting.
- Review financial statements and accounting principles.
- Make an overall evaluation of the financial conditions by applying tests of the appropriate ratios.

**TEST 1**

**CURRENT RATIO**

$$\frac{\text{Current Assets (Cash + Acct. Recv. + Inventory)}}{\text{Liabilities (Acct. Payable + Fed. Inc. Tax. Payable + Misc. Acct. Payable)}} = \text{Current}$$

## TEST 2

### ACID TEST RATION

$$\frac{\text{Cash} + \text{Net Receivables} + \text{Current Marketable Securities}}{\text{Current Liabilities}}$$

## TEST 3

### ACCOUNTS RECEIVABLE TURNOVER

$$\frac{\text{Net Credit Sales}}{\text{Average Balance of Trade Accounts Receivable}}$$

## TEST 4

### INVENTORY TURNOVERS

$$\frac{\text{Annual Cost of Goods Sold}}{\text{Average Inventory}}$$

## TEST 5

### AVERAGE # OF DAYS SALES IN ENDING INVENTORY

$$\frac{\text{Ending Inventory} \times 365 \text{ Days}}{\text{Cost of Goods Sold}}$$

## TEST 6

### DEBT TO EQUITY RATIO

$$\frac{\text{Total Debt}}{\text{Total Stockholders' Equity}}$$

In analyzing these ratios, consider several factors. Generally, from a creditor's point of view, the higher the current and acid-test ratios and the shorter the operating cycle, the

better. However, excessive current and acid-test ratios are unfavorable in management's view.

Similarly, an unusually high rate of inventory turnover may indicate that the company is losing business by failing to maintain an adequate supply of goods, but a creditor may look favorably upon a high turnover rate.

A high rate of accounts receivable turnover may indicate that the company's credit policies need to be relaxed to encourage more business, while a low debt to equity ratio may indicate a substantial margin of protection against insolvency.

For the purposes of determining the solvency or insolvency of the taxpayer, a comparison of ratios over time is more revealing than studying single measurements. A stable position or a degenerating financial condition may be revealed by analyzing the trends. However, do not rely solely on these ratios to determine solvency or insolvency. If the trend is favorable or unfavorable, make further inquiry as to the underlying reasons.

## **Fraud**

The statutory authority for assessment of a tax due to fraud is contained in MGL 62C, section 26(d) and section 28. Chapter 62C, section 26(d) provides that...in the case of a false or fraudulent return filed with intent to evade a tax or a failure to file a return, the Commissioner may make an assessment at any time, without giving notice of his intention to assess, determining the tax due according to his best information and belief.

Chapter 62C, section 28 provides that...if a person has filed a false or fraudulent return or has filed a return with a willful attempt in any manner to defeat or evade the tax, the Commissioner may determine the tax due, according to his best information and belief, and may assess the same as no more than double the amount so determined, which additional tax shall be in addition to the other penalties provided by this Chapter.

Every auditor in the Audit Division is responsible for the early recognition and timely referral of potential tax evasion cases to the Criminal Investigations Unit (CIU).

The mission of CIU is to gather and develop information establishing the commission of a tax crime. CIU investigates all types of tax crimes. Once developed, the cases are referred to the Attorney General for prosecution.

Taxpayer interviews and books and records verification provide opportunities to detect potential tax fraud or tax evasion schemes warranting referral to the Criminal Investigations Unit.

In order to assert fraud, actual fraud must be present. Actual fraud is defined as:

**"...deceit, trickery; specifically deception intentionally practiced to induce another to part with property or to surrender some legal right..."**

In tax matters, fraud is present where there is the integration of these important factors:

- Taxpayer pays less tax than what is due;
- Taxpayer deliberately and intentionally remits less tax; this is not due to an honest error or a misunderstanding of taxability; and
- The ends are achieved by the deliberate and intentional action of the taxpayer.

To successfully prove fraud, it is necessary to establish that a part of the deficiency is due to a false representation of facts by the taxpayer and that the taxpayer had knowledge of the falsity and intended that it be acted upon as truth.

The assertion of fraud must be supported by clear and convincing evidence and not rest merely upon suspicion or presumption.

Factors to be considered:

- The responsibility for the actions can be attributed only to the taxpayer and not blamed on another;
- The circumstances are flagrant in nature and were intended to reduce the tax liability through deception or falsification;
- The amount of tax deficiency caused by the fraudulent activity is material with respect to the total tax liability; and
- The evidence of fraud is available and obtainable.

A fraud situation exists most often for cases in which tax collected is not remitted. A pattern can usually be found, such as:

- Duplicate invoice numbers with different names;
- Erasures in journals and ledgers;
- Invoices do not match journals/ledgers;
- Figures do not trace through the accounting system, especially through to bank records, which are externally generated;
- Information or an admission obtained from an employee, especially a bookkeeper;
- Vendor records/customer records that do not match source documents;
- External records such as affidavits, court records, etc., that do not match source documents; and/or
- Changing names on collected invoices to names of exempt customers (and erasing the tax).

There are other fraudulent activities besides tax collected but not remitted such as falsifying motor vehicle trade-in values, etc.

## **Criminal Fraud vs. Civil Fraud**

The basic elements are the same. The difference is in the degree of action or inaction. In civil fraud, the degree of proof necessary is that the evidence must be clear and convincing that the taxpayer acted with willful intent to defeat or evade the tax. In criminal fraud, the degree of proof necessary is that the evidence that must show beyond a reasonable doubt that a taxpayer acted willfully with intent to evade or defeat the tax. This evidence is based on normal knowledge in everyday life and not on the knowledge of an expert.

The Criminal Investigations Unit (CIU) of the Litigation Bureau housed within the Legal Division is responsible for investigating potential criminal tax fraud cases based on referrals made to the Fraud Referral Coordinator (FRC) within the unit.

The Civil Fraud Unit is part of the Desk Examination Unit, Bureau of Desk Audit, within the Audit Division. This unit handles established criteria for Earned Income Credit (EIC) issues and Fraud Detection.

### **Burden of Proof**

The state has the burden of proof in upholding a civil fraud assessment, which means the auditor must document with clear and convincing proof showing the taxpayer's guilt. Documentation includes but is not limited to copies of exceptions, written details of the exceptions, a listing of events that led to the scheduling of exceptions and the reasons the exceptions are considered to be fraudulent.

The Attorney General's office prosecutes tax crimes on behalf of the Commonwealth. The Department of Revenue must prove an element of a tax crime charge that the taxpayer's conduct was willful by demonstrating that the taxpayer's actions constituting fraud or evasion were part of a pattern of activity sufficient to overcome the explanations of negligence or awareness.

### **Procedures for Recommending a Referral**

When indications of fraud are discovered during the course of an audit, the auditor will gather as much evidence as necessary to document the fraud pattern.

The auditor should contact his/her supervisor for additional guidance in obtaining necessary evidence. When sufficient information has been gathered, an Audit Referral Form CIU-1 should be completed. The auditor should also prepare a memo detailing the events that explain the documentation and the auditor's position. The auditor must send these documents, through his/her Director and Bureau Chief for transmittal to CIU.

Once the audit has been referred for possible investigation for criminal charges, the auditor should not proceed with the audit until instructed to do so by the Criminal Investigator assigned or the Fraud Referral Coordinator. The auditor will not hold an exit

conference with the taxpayer unless instructed to by CIU. If the taxpayer has any questions about the audit, the auditor will refer the taxpayer to the assigned Criminal Investigator, or the Fraud Referral Coordinator, and will not discuss the audit.

### **Application of Civil Fraud**

To successfully sustain a civil fraud assessment, it is necessary to establish, in detail, that a part of the deficiency is due to the misrepresentation of facts by the taxpayer and that there was knowledge of the falsity and that the falsity be acted upon as truth. The evidence must include the actual documents or exact copies of the documents or information.

If an auditor determines the existence of a pattern of non-reporting or under reporting of tax with intent to defraud the Commonwealth, he/she should immediately discuss findings with his/her supervisor/manager and initiate the following course of action:

- Suspend audit as soon as sufficient information has been obtained to document a CIU referral.
- Discontinue all taxpayer contact after you and your supervisor have determined that there is sufficient data to warrant a referral to CIU.
- Promptly fill out a CIU Referral Report (Form CIU-1).

After compiling the audit case file containing the completed referral form, copies of source documents and all original work papers, the case is reviewed by the Manager/Director to assure that the facts and documentation supports a potential fraud case.

The Manager/Director will examine the case and concentrate on the following areas of the referral:

- The books and records examined by the auditor and documents maintained by the taxpayer;
- Documentation to support suspicion of fraud;
- No issuance of NIA or soliciting returns;
- No advice and direction from CIU on the actual case;
- The referral meets the criteria of willful tax violation(s);
- Written details of the taxpayer's explanation for potential criminal behavior, i.e., failure to file, failure to pay or under reporting.

If the Manager/Director agrees that the case should be referred to CIU, the Manager/Director will send the case to the Bureau Chief on a transmittal form and add a case flag to AWB-Case Summary to alert users that the case was transferred to CIU. The Manager/Director can easily enter a description of the case or date the case was transferred to the Bureau Chief to be forwarded to CIU in the note text box.

The Manager/Director is responsible for protecting the Statute of Limitations for assessment and the monitoring of the open case while in CIU's custody.

## **Auditor Responsibility**

When an audit has been accepted for criminal investigation, the auditor may still have to spend some additional time working with the investigator. The responsibility of the auditor includes any examination of additional records obtained during the investigation, explaining audit schedules and audit procedures to the investigator. The auditor must keep his/her supervisor fully informed as to the requests made by the investigator of the auditor's time.

## **Application of Criminal Fraud**

The successful prosecution of tax law violators is important to the fair and uniform administration of state tax law. All Department personnel share in the responsibility of identifying tax fraud.

Revenue fraud may be depicted in a variety of ways. The most obvious is the failure to file a return, but many schemes are initiated to either understate income or to overstate expenses. "Badges of Fraud" are used as indicators and should raise the question of potential criminal fraud or evasion in the mind of the auditor.

Examples are: omissions of specific items of income where similar items were reported in the past, false or misleading statements, large currency transactions, failure to file returns for several years although substantial taxable income was received, maintaining a double set of records or no records, loose internal controls of cash receipts, false entries in books or alteration of records, the destruction of books or records including records lost from fire, theft or flood, a substantial net worth increase incommensurate with reported income, excessive personal expenditures, unexplained bank deposits, false or overstated deductions or exemptions, substantial understatement of income over a number of years, unusual handling of business receipts such as the failure to deposit checks received as receipts to the business bank account or the cashing of those checks and any conduct which would likely have the effect to mislead someone or to conceal something.

## **Auditor Responsibility**

The potential for misuse of the criminal investigation by the Department through its extensive civil enforcement powers make the court and the Attorney General reluctant to entertain a case that has substantial disguised civil involvement. Simply put, we cannot conduct a criminal investigation under the guise of a civil examination.

When an audit has been identified as a potential fraud referral, the tax auditor can adversely affect the prosecution potential of a case in three principal ways:

1. By soliciting an agreement to proposed tax increases including the issuance of an NIA;
2. Soliciting and actually receiving a delinquent tax return; or

3. Obtaining advice and direction from CIU concerning a specific case prior to the making and accepting of a criminal referral.

When suspicion of fraud or evasion arises in an auditor's mind, he/she should write the results of his contact with the taxpayer and/or taxpayer's representative which should be incorporated into the AWB-Case Log. Any future contact should be maintained in written form as well. Important items to note are dates and admissions of the taxpayer regarding the existence of records for the periods involved and their custodian. Also, any altered bookkeeping, accounting records maintenance procedure, false or misleading statements and any general statements made or actions taken by the taxpayer which would assist CIU in evaluating the intent to evade taxation.

## Chapter 7

### Sales/Use Tax Auditing Procedures

#### Introduction

The primary purpose of the sales/use tax audit is to confirm that the taxpayer has reported the correct amount of tax. Reported amounts on the sales tax history must be analyzed when examining the taxpayer's records as well as its purchases for resale and non-exempt use.

#### Sales Tax

In accordance with M.G.L. Chapter 64H, Massachusetts imposes a 6.25% sales tax on the sales price or rental charge on tangible personal property or certain telecommunication services sold or rented in the Commonwealth. The sales tax is paid to the vendor in addition to the sales or selling price. The buyer pays sales tax to the vendor of tangible personal property; then the vendor remits the tax to the Commonwealth. (See M.G.L. Chapter 64H, section 1 for additional information regarding "sales", "sales price", "sale at retail", "services", "tangible personal property" and "telecommunication services", etc.).

**Note:** For motor vehicle and trailer sales, the sales tax is paid directly to the Commonwealth by the purchaser. (See CMR 64H.25.1).

#### Use Tax

In accordance with M.G.L. Chapter 64I, Massachusetts imposes a 6.25% use tax on the sales price or rental charge on tangible personal property, including mail order items or items purchased via the Internet, or certain telecommunication services where no sales tax, or a sales tax rate less than the 6.25% Massachusetts rate was paid, which are to be used, stored or consumed in Massachusetts. In general, the use tax is paid directly to the Commonwealth by the purchaser. (See M.G.L. Chapter 64I, section 1 for additional information regarding "purchase and purchased", "purchaser", "store", "storage", and "use", etc.).

#### Administrative Details

##### Identifying Responsible Person(s)

In order to facilitate the collection of tax liabilities imposed on corporations and partnerships by MGL chapters 62B, 64G, 64H and 64I, auditors must identify the responsible person(s) who are liable for such trustee taxes pursuant to M.G.L. Chapter 62C, section 31A and 830 CMR 62C.31A.1.

The identification of responsible persons must be done for all trustee tax audits. Auditors must document in the audit narrative and Audit WorkBench (AWB)-Case Log the names of the individual(s) responsible for paying over the trustee taxes. This information must also be entered into the MASSTAX system under the taxpayer "note" screen.

### **Bank Account Information**

During the course of the examination, the auditor must gather the following information relating to the taxpayer's banking activity:

- Name of bank(s) in which the taxpayer has account(s); and
- Account(s) numbers.

If the taxpayer has more than three (3) accounts, the auditor must get the above information for the taxpayer's three primary accounts. The information must be noted in the audit narrative and documented in the MASSTAX system under the taxpayer "NOTE" screen.

### **Bankruptcy Information**

When a taxpayer files the bankruptcy case, the automatic stay prohibits all of the taxpayer's creditors, including the Department of Revenue, from taking any action to collect any debts or liabilities that relate to the time period before the Petition Date. During the course of the initial taxpayer contact, the auditor should ask the taxpayer if they are in bankruptcy. If the taxpayer is in bankruptcy, the auditor must obtain the following information and forward it to the Litigation Bureau's Bankruptcy Unit immediately:

- The location of the Bankruptcy Court;
- The Bankruptcy Court docket number (stamped on the bankruptcy petition); and
- The petition date (the date the bankruptcy case was filed).

The information must be noted in the audit narrative and Audit WorkBench (AWB) - Case Log to ensure the necessary steps are taken to contact the Bankruptcy Unit in a timely fashion.

**Note: Bankruptcy procedures are discussed in detail within Chapter 6-Specialized Audit Procedures of the Field Audit Procedures Manual.**

### **Case Plan**

The Audit WorkBench (AWB)-Case Plan will be used to guide the progression of each case. The case plan is structured to allow for flexibility of workflow and is broken into primary tasks and subtasks. When all of the subtasks are completed within a certain

primary task, it will automatically be recorded in Audit WorkBench-Case Log. The

Primary Tasks are as follows:

- Pre-Audit Analysis:
  - The steps involved in completing this Primary task entail documenting the source of audit and audit period;
  - Prepare the taxpayer history and review the applicable prior audit reports;
  - Research the taxpayer's website on the internet;
  - Discuss the audit plan with the supervisor/manager;
  - Contact taxpayer by telephone to schedule an opening conference;
  - Issue the confirmation letter and checklist/document information request through Audit WorkBench-Notice Generation.
  
- Initial Audit Review:
  - Within the New England Audit Bureau, the opening conference is conducted with the supervisor, auditor and taxpayer to discuss the audit parameters communicating the Taxpayer's Bill of Rights, conduct a tour of the facility, ascertain any prior audit information availability, obtain the necessary Power-of-Attorney Form M-2848 and/or obtain an executed Consent for Extending the Time for Assessment, Form A-37 (if applicable);
  - Within the Multistate Audit Bureau, the opening conference is conducted with the auditor and taxpayer to discuss the audit parameters communicating the Taxpayer's Bill of Rights, conduct a tour of the facility, ascertain any prior audit information availability, obtain the necessary Power-of-Attorney Form M-2848 and/or obtain an executed
  - Consent for Extending the Time for Assessment, Form A-37 (if applicable);
  - Determine the account, periods and populations to be tested or reviewed in their entirety, applicable to transaction taxes only;
  - Discuss the availability of electronic records and/or the merits of conducting the audit using Computer Assisted Auditing Techniques (CAATs), applicable to transaction taxes only;
  - Document the reasons for the selection of the test periods;
  - Issue appropriate Audit Division forms.
  
- Audit Review and Documentation:
  - Reconcile and analyze the taxpayer's books and records including the transaction tax returns, sales journals, general ledgers, Massachusetts state tax returns, federal tax returns and supporting schedules, apportionment work papers, 10K reports, financial statements and other

records of the taxpayer and prepare comparative schedules to determine the accuracy of the records and document if any adjustments are required;

- Examine the taxpayer's records including sales, fixed assets, expenses, other applicable categories, document all exceptions to support the audit findings and issue the 60-day Notice of Exceptions to the taxpayer for invalid or missing exemption certificates\*, applicable to transaction taxes only;
  - Determine, research and resolve legal and/or policy issues with management;
  - Provide the taxpayer with copies of the preliminary audit work papers which are pending review by the supervisor or manager and are subject to change.
- Findings and Reporting - Supervisory Review and Exit Conference Procedures:

#### **A. New England Audit Bureau**

- Review the audit with the supervisor prior to the exit conference and discuss any unresolved issues;
- Conduct the exit conference with the taxpayer, review the auditor's findings and provide statutory citations, case law and DOR pronouncements to support the audit adjustment including error factor and projection calculations;
- Include the Exit Conference Report prepared by the supervisor/manager in the electronic audit case folder;
- Document the final results for review and approval by the supervisor/manager including all pertinent information and documents scanned and attached to the electronic audit case folder;
- Prepare applicable audit referrals and scan and attach documents to be forwarded to the appropriate bureaus by the supervisor/manager via electronic means;
- Key the assessment into Audit WorkBench-Assessments, allocate the audit issues and auditor credit, prepare the Notice of Intention to Assess (NIA) through the Interface Details link, validate the assessment and seek case approval based on dollar threshold;
- The supervisor/manager prepares and sends the Exit Conference Letter to the taxpayer or representative along with Forms B-37 and DR-1 explaining the audit findings and informing the taxpayer of their appeal rights and attach the letter to the electronic audit case folder;
- The supervisor/manager interfaces the assessment to issue the NIA upon final management approval of the case in Audit WorkBench(AWB); and
- If requested, the supervisor/manager prepares the case file for the Office of Appeals (OOA) which includes executing Form B-37, updating the SOL date to 12/25/2027 on Audit WorkBench(AWB)-Period Details, scanning and attaching Forms B-37 and DR-1 to ready the electronic audit case folder for OOA.

## **B. Multistate Audit Bureau**

Based upon logistics, the Multistate Audit Bureau presents findings to a taxpayer via a process involving a "10-day Letter" after the auditor submits the completed electronic audit case file for supervisory review. The "10-day Letter" is accompanied by copies of work papers which have been reviewed and approved by the manager. It provides the taxpayer with concise written explanations of the adjustments. The letter affords the taxpayer a period of ten days to review the work papers and then decide whether, at its option, it wishes to have an exit conference. Within Multistate, exit conferences may be in person or via the telephone. Alternatively, a taxpayer may submit its position in writing along with supporting documentation for consideration. Once the exit conference is held:

- Document the final results for review and approval by the supervisor/manager including all pertinent information and documents scanned and attached to the electronic audit case folder;
- Prepare applicable audit referrals and scan and attach documents to be forwarded to the appropriate bureaus by the supervisor/manager via electronic means;
- Key the assessment into Audit WorkBench-Assessments, allocate the audit issues and auditor credit, prepare the Notice of Intention to Assess (NIA) through the Interface Details link, validate the assessment and seek case approval based on dollar threshold;
- The supervisor/manager prepares and sends the Exit Conference Letter to the taxpayer or representative along with Forms B-37 and DR-1 explaining the audit findings and informing the taxpayer of their appeal rights and attach the letter to the electronic audit case folder;
- The supervisor/manager interfaces the assessment to issue the NIA upon final management approval of the case in Audit WorkBench(AWB); and
- If requested, the supervisor/manager prepares the case file for the Office of Appeals (OOA) which includes executing Form B-37, updating the SOL date to 12/25/2027 on Audit WorkBench(AWB)-Period Details, scanning and attaching Forms B-37 and DR-1 to ready the electronic audit case folder for OOA.

### **Opening Conference - Additional Topics to Be Covered in a Sales/Use Tax Audit**

A field audit begins with an opening conference. In addition, the auditor is expected to secure additional detail about the taxpayer that will be used to conduct the audit more efficiently and identify issues for review. Prior to the opening conference, the auditor will prepare a list of questions to be addressed to obtain an overview of the entire operation of the business and also identify probable problem areas of tax liability or credit prompting the auditor to raise additional questions when appropriate during the interview. For example, the taxpayer or taxpayer's representative should be asked to explain or provide the following:

- The reporting method utilized.
- The step-by-step process by which the information is obtained and summarized to prepare the return. (This information includes the records used to prepare the return.)
- Any work papers used to prepare the return. (These should be checked for completeness and whether they include all areas subject to tax.)
- General Ledger accounts that have been used by the taxpayer in reporting. (Check for related accounts when the Chart of Accounts is reviewed.)
- Changes in personnel who prepared the return. Obtain the name and position of anyone who prepares a specific portion of the return.
- Resale/exemption certificates for tax-free sales.
- Items included in deductions and taxable purchase.
- Unusual areas (i.e., changes in reporting method, etc.).
- If the reporting method has been changed, check the different methods used and document the changes in the Audit WorkBench (AWB)-Case Log.
- What items the taxpayer is claiming as deductions.
- All categories of revenue, sales of equipment, parts, labor, services, consulting.
- Billing & collection procedures for all sources of revenue through the accounting system; including cash and charge sales, credits, shipments and destinations.
- The self-assessment or the accrued tax liability procedures.
- Purchasing procedure for inventory, supplies, expenses and fixed assets.
- Accounts payable process including receiving and approving for payment, account distribution, returns, checks and remittance advice.

As soon as practical after completion of the opening conference, the auditor should schedule a tour of the taxpayer's facility. This will frequently identify other issues to be addressed during the audit. The auditor may dispense with the tour if is not expected to be of value. If, as the audit progresses, the auditor determines that a tour would be relevant; it should be requested in writing.

Both the opening conference and the tour (or the decision to forego the tour) must be documented in the Audit WorkBench (AWB)-Case Log.

### **Analyze Reporting Categories**

Reporting categories are broken out as follows on the sales tax return in WebFile for Business (WFB):

1. Gross Sales
2. Sales for resale/exempt sales or other adjustments 2A.  
Sales of materials, tools and fuel
- 2B. Sales of machinery and replacement parts
3. Total non-taxable sales (sum of 2, 2A and 2B)
4. Taxable sales (line 1 minus line3)
5. Use tax purchases
6. Total taxable amount (sum of line 4 and line 5)

Audit procedures used in each audit situation will be adapted to the individual taxpayer's system of accounting and record keeping. Since different reporting methods are used by taxpayers to complete sales tax returns, it is important that the auditor understand the method utilized by the taxpayer. The auditor should complete an analysis of the accounting system and devise specific audit procedures applicable to the audit. Certain procedures must be performed on each audit (i.e., tax reconciliation, gross sales reconciliation, examination of purchases, etc.).

## **Preliminary Audit Review Common**

### **Reporting Methods**

The common methods frequently used by taxpayers for reporting sales tax are:

- Reporting taxable sales only;
- Determining taxable sales by backing into taxable sales by dividing tax billed by the tax rate or tax collected by the tax rate;

Reporting gross sales and determining deductions by backing into taxable sales; and Reporting Massachusetts's destination sales only and determining deductions by backing into taxable sales.

Any of the above methods plus any other method employed must be audited to verify gross sales, sales subject to Massachusetts's sales tax and deductions qualifying as exempt sales.

### **Review of Internal Controls**

The taxpayer's system of internal control must be analyzed and evaluated to determine the reliability of the records being examined. The depth of the audit examination is determined in great part by the reliability of the taxpayer's internal control system.

### **Characteristics of Good Internal Controls**

Some characteristics of good internal controls are listed below. Each system must be analyzed for specific strengths and weaknesses.

- A clearly defined separation of responsibility for each function;
- An adequate system of authorization;
- Adequate supervision of duties;
- Adequate documentation;
- Adequate protective measures (i.e., locked rooms for inventory, etc.);
- Segregation of duties;
- Internal audit verification system;
- Operating Procedures Manual; and

- Outside verification (Public Acct. Firm) audited and prepared financial statements.

### **Total Sales**

Total sales consist of all taxable and nontaxable sales made during the reporting period. Sales tax collected should not be included in reported total sales.

### **Internal Controls**

Generally, verification of total sales includes:

- Reviewing the Chart of Accounts for revenue accounts;
- Reviewing the taxpayer's method of reporting sales;
- Reconciling recorded and reported amounts;
- Determining which accounts make up total sales;
- Determining how cash sales are handled;
- Determining how credit sales are handled;
- Determining how bad debts are handled; and
- Reviewing method of billing all shipments and other revenues.

### **Reconciliation of Recorded and Reported Sales**

Reconciliation should be performed by comparing reported sales (per the sales tax return) with audited sales (per books and records). This reconciliation may be completed by report period or by year. **Taxable and non-taxable** transactions should be reviewed.

Reported total sales should also be compared to:

- Federal Income Tax Returns
- Massachusetts Personal Income (Schedule C)
- Financial Statements
- Mass. Corporate Excise (Schedule F)

Any differences found between reported and audited sales should be analyzed considering the taxpayer's reporting method. Determine if the differences result from taxable or nontaxable sales. Audit adjustments should be made for unreported taxable sales.

If no differences are noted, then document this fact in the Audit WorkBench (AWB)- Case Log.

## **Preliminary Review of Taxpayer Records**

Preliminary reviews should be done before a thorough examination of records is performed. This review will provide the necessary information to determine whether to perform a detailed audit or to employ sampling procedures. Highlight key areas that may need a more detailed examination. Before relying on taxpayers' records, conduct a review of the following:

- Testing one or two reports to verify that the procedures as explained are used to prepare the return;
- Postings in sales journals to general ledgers;
- Recording of daily sales totals or invoices to sales journals;
- Sales journals footings (totals);
- Unusual entries in journals and ledgers; and
- Recording accuracy, records flow, tax charged and rate of tax.

If the preliminary review reveals that summary records accurately reflect the taxpayer's method of accounting, then use the taxpayer's summary records. If not, then an examination of the original source document may be necessary. Document your findings in Audit WorkBench (AWB)-Case Log.

## **Sales/Use Tax Audits Procedures**

The use of sampling techniques represents an effective method by which the Commissioner of Revenue may carry out the duty of tax administration. The use of sampling can contribute significantly to the overall goals of maximizing audit coverage and encouraging proper reporting practices. These goals, which benefit all Massachusetts' taxpayers, must be balanced by careful analysis and planning.

The Commissioner of Revenue has statutory authority to conduct sample audits. Massachusetts General Law, Chapter 62C, section 24 defines this authority:

If the books, papers, records and other data of the taxpayer are so voluminous as to make a complete audit thereof impractical and inefficient, the commissioner may use such statistical sample methods in conducting such audit as may be agreed to by the parties and project the audit findings derived there from over the entire audit period to determine the proper tax. If, after a good faith effort, the parties cannot reach such an agreement, the commissioner may utilize such statistical sample methods, which he deems appropriate and which comply with the provisions of the Internal Revenue Code.

Computer Assisted Auditing Techniques (CAATS) is a way to streamline the audit process by completing an efficient, understandable and accurate audit through the use of electronic records where statistical sampling validates the transaction base and provides a clear audit trail needed to determine the proper tax due or to propose adjustments to tax reported. CAATS is the preferred method for sampling. If CAATS is not to be used for sales or expenses, the auditor should make a note in the Audit

WorkBench (AWB)-Case Log and narrative as to the reasons for not using CAATS (e.g. different accounting systems used throughout the audit period, paper records, etc.) All medium sized and larger taxpayers should be requested to complete and return the CAATS Questionnaire.

Whenever possible, the Audit Division will employ the use of ACL software to conduct a statistical sample of the records as found in "A Guide to Computer Assisted Auditing Techniques" located on the Department of Revenue's website at [www.dor.state.ma.us](http://www.dor.state.ma.us).

Block Sampling is another way, which allows the auditor to choose only those areas of a taxpayer's business, which would most apt to be subject to the imposition of either a sales tax or on the purchase side a use tax. The goal of testing or sampling is to determine the level of tax compliance for a taxpayer by identifying transactions in which non-compliance exists during certain test period (s) within the entire period. Test sampling requires a certain level of standardization, but must also maintain a degree of flexibility due to the uniqueness of each taxpayer's record-keeping and overall accounting system. Electronic records are encouraged to facilitate the data entry process. As such, auditors should request records in electronic format whenever possible, and should note such requests in the Audit WorkBench (AWB)-Case Log.

### **General Policies and Procedures on Sampling**

The following general policies regarding sampling have been established by the Audit Division and should be used in the conduct of tax audits as required:

- Written notification of the sampling procedures will be given to the taxpayer when it is first determined that sampling will be conducted.
- The notification will be hand delivered whenever possible (otherwise, mailed) and must be given or sent to the person designated by the taxpayer to make decisions regarding the conduct of the audit.
- All notifications given to the taxpayer will be stored in the electronic audit case folder in Audit WorkBench (AWB)-History.
- Upon reaching agreement on sampling procedures, the taxpayer and auditor will execute a written agreement to use a representative test.
- If, after a good faith effort, the parties do not reach an agreement to use a representative test, the auditor, after notifying the taxpayer in writing, may perform a representative test using those methods that are reasonably calculated to reflect taxes due the Commonwealth.
- Sampling will be considered for use in every audit situation where the conditions of the business and records meet the criteria authorized by the statute.
- Asset purchases will be detailed unless the auditor has established that a consistent and recurring pattern of acquisition exists.

## **The Sampling Process**

Each step in the sampling process involves a choice of several alternatives. As the sampling plan is being developed, it is important to keep the steps in mind. Broadly stated, these steps are:

- Define the population to be audited.
- Determine appropriate stratification of the population such that the strata are relatively homogenous populations;
- Choose the type of sampling unit;
- Determine the sample size;
- Establish correspondence;
- Select the sample units;
- Perform a preliminary sample examination;
- Complete the sample examination;
- Evaluate the sample results; and
- Project the results to the population.

## **Sampling - Preliminary Testing**

These tests are undertaken for the purpose of determining the overall accuracy and completeness of the taxpayer's reporting system and the existence of good internal controls. Areas to be tested in the initial stage are the systems for reporting gross sales and the system for reporting use tax.

- Are all sales properly reported on a Massachusetts destinations basis?
- Are the deductions accounted with properly supported resale certificates (Form ST-4), exempt use certificates (Form ST-12), exempt purchase certificate (Form ST-5C), etc.?
- Other adjustments such as return of property within 90 days from the date of sale?
- Is property purchased from non-registered vendors properly accrued and timely reported for use tax purposes?
- Is property purchased with an exempt use status proper?
- Is property purchased originally exempt later used by the company in a taxable manner?

## **Notice Requirement**

Audit Division policy requires that written notification be given to taxpayers of the sampling procedures to be used in the conduct on an audit prior to utilizing a sample technique to determine the proper amount of tax.

The notice should include sufficient detail for the taxpayer to fully understand the sampling procedures. This usually requires a general reference to the methodology and specific references to the taxpayer's unique circumstances. When all parties agree to

the sampling procedures, Agreement to Use Representative Test should be presented to the taxpayer for signature and documented in the Audit WorkBench (AWB)-Case Log. The auditor must remember to issue a separate Agreement to Use Representative Test for each examination where the findings will be projected. All notices generated will be recorded in Audit WorkBench (AWB)-History, which stores an exact image of the notice sent to the taxpayer. The notice can be viewed, but cannot be edited to maintain the integrity of the document.

The Notification of Sampling and Representative Test Agreements for Block and CAATS sampling are referenced below.

## **Detailed Procedures For The Audit of Sales General**

### **Ledgers**

Examine general ledger accounts for debits and credits that may represent unreported taxable sales such as:

- Sales of merchandise at cost credited to purchase or inventory accounts;
- Sales of by-products credited directly to profit and loss, surplus or expense accounts; and
- Sales of furniture, equipment or other capital assets credited to equipment, depreciation, gain or loss or other accounts. In general, this is a casual and isolated sale unless the taxpayer is regularly engaged in selling fixed assets "leasing company" (See Regulation 830 CMR 64H.6.1).

Account for all sources of revenue:

- Review the taxpayer's Trial Balance for audit periods;
- Compare Trial Balance figures to Massachusetts personal income/corporate excise return;
- Compare Federal Return to Trial Balance;
- Review Chart of Accounts for any additional questionable sales or revenue accounts;
- Inquire if taxpayer engages in e-commerce (internet sales) in which no sales invoices are generated;
- Determine how activity is tracked and reported;
- Identify all categories of sales that are subject to tax and reconcile to gross revenue; and
- Verify taxable sales and identify and list deficiencies.

In the case of large multistate corporations, auditors should determine the feasibility and materiality of performing these tasks prior to applying these procedures.

## **General Journals**

Examine the general journal and note entries that may indicate unreported taxable sales.

Consider all data pertaining to general journal entries in determining if an entry represents an unreported taxable sale. This data may include:

- Correspondence
- Contracts
- Invoices and other documents

## **Cash Receipt Journal**

Examine the cash receipts records to determine whether receipts from cash sales have been credited to the proper sales or revenue accounts. Be careful not to duplicate taxable sales found in other records. Verify postings to accounts receivable account.

- Prepare a Bank Deposit Analysis to test the relationship between cash receipts and recorded gross receipts when dealing with companies selling mainly taxable items and/or those engaged in small retail operations. This step may not be possible for a large national/international entity.

## **Accounts Receivable Ledger**

Examine the accounts receivable from the owners, partners, officers or employees of a firm for evidence of taxable sales not otherwise recorded in the sales or revenue accounts. Examine partners' draw accounts and employees' advance accounts.

## **Purchase Journal**

Entries may be made in the purchase journal for sales at cost or returned merchandise. Inventory withdrawals that should have been reflected in the inventory accounts may also appear as credits in the purchase journal. Examine these postings for taxable sales because inventory withdrawals could be subject to a "use tax" or a "sales tax" depending upon whether an exemption certificate had been issued by the taxpayer to the vendor of the item(s). The auditor should fully explore this issue when items were purchased from a Massachusetts vendor. See MGL Chapter 64H, sections 8(d) and 8(h), and Chapter 64I, sections 8(e) and 8(j). Any assessments made based upon these sections should be cited in the free form comments section of the Notice of Intention to Assess (NIA), the supervisor's or manager's Exit Conference Letter and the audit work papers.

## Sales Invoices and Journals

Sales invoices are source documents and usually represent the original record of a transaction. It is a necessary part of audit procedure to examine a representative number of these invoices to determine:

- How the transactions are recorded on the invoices?
- How is labor billed and accounted for? Installation - fabrication and assembly?
- If tax was properly assessed, was tax properly recorded in journal?
- How are the invoices filed? By invoice number? By customer's name? By days? By months?
- How are deliveries made and billed?

### Invoices are used to verify:

- Postings
- Tax accruals
- Deductions
- Zero Invoices
- Types of transactions

**Postings:** Here is the first step in verifying the accuracy of the books of original entry. The sales invoice is traced directly to the sales or revenue journal for accuracy of posting relative to amount and classifications. Trace source documents through to summary records and check for errors and omissions.

### Determine if:

- They are consistent.
- There is a posting from each source for each month or accounting cycle.
- There are sources of postings that might reveal operations not disclosed in pre-audit research or discussions with the taxpayer.

**Tax Accruals:** The tax assessed on the invoice is important because the tax accrual amount is based on the tax rate times the taxable value. This information is especially important on audits of taxpayers that derive total sales, taxable sales or deductions based on the amount of tax accrued. The taxable sales should be determined by reporting proper gross sales and identifying exempt sales as a deduction from gross sales.

**Deductions:** Note what type of deductions the taxpayer is claiming because they may lead to a detail of certain accounts.

**Zero Invoices:** A zero invoice in many cases may indicate that the taxpayer is sending samples or tangible personal property to a customer free of charge or withdrawing

inventory for their own use. These should be reviewed just as a regular invoice. If the auditor determines that items are given away free of charge, or otherwise used for purposes other than resale, tax may be due on the cost of the property given away.

**Types of Transactions:** For the sale of tangible personal property or taxable telecommunication services, examine invoices to determine if charges are consistently separated or billed as a lump sum. This information is also important to know when examining purchases. If there is a lump sum charge that includes both taxable and nontaxable amounts, the entire charge is taxable unless the taxable amount is inconsequential. Otherwise, to be excluded from the taxable amount, the nontaxable items must be separately stated on the invoice or other billing document.

### **Federal Income Tax Return**

A comparison of gross receipts and other income reported for federal income tax purposes with state sales and use tax returns is a good audit practice. This comparison may be a difficult analysis to perform if the taxpayer files a consolidated federal income tax return. However, the taxpayer should have working papers showing how these figures were obtained.

Reconcile the differences between the reported figures. **Material differences should be analyzed.** Determine if the difference is the result of taxable versus nontaxable sales or Massachusetts and non-Massachusetts's sales. Also review Schedule D of the federal income tax return for any fixed asset sales.

In making this reconciliation, differences may be due to:

- Timing.
- Accounting basis (reporting on cash basis for income tax purposes and using an accrual basis for sales and use tax purposes or vice versa). An analysis should be made of the tax accrual or payable account to identify all sources of liability for taxes and the appropriate adjustments.

### **Sales Tax Verification**

Sales tax billed versus sales tax reported should be reconciled in detail for every audit. Total sales should not include tax billed but:

If a taxpayer does not separate tax and selling price (total sales figure includes tax), determine if:

- Total amounts (including tax), of sales invoices are included in the Gross Receipts when entered into the sales/revenue journal including exempt sales. Tax should be segregated and accounted for in a separate column and booked in the Liability Account through the Sales Journal.

- The price and tax rung up on the cash register is recorded in the Cash Receipts Journal. Massachusetts's sales tax should be separately stated.

Then determine total sales by:

- Reducing the total sales figures (tax included) by the amount of tax-exempt sale to arrive at total taxable sales (tax included).
- Dividing total taxable sales (tax included) by one plus the appropriate tax rate to arrive at total taxable sales (tax excluded).

Add total taxable sales (tax excluded) and tax-exempt sales to obtain a total sales figure.

### Sales Tax Verification, Example

The total amount of sales of ABC Company is entered in the cash receipts journal. The taxpayer also made exempt sales to a state agency, and these exempt sales were included in the cash receipts journal. Figures from the cash receipts journal show:

Total Sales (tax included)	\$ 13,281.25
Less: Exempt Sales	< 2,000>
Equals: Total Taxable Sales (tax included)	<u>11,281.25</u>
Total Taxable Sales (tax excluded)	
equals \$11,281.25	
divided by 1.0625	\$ 10,617.25
Add:	
Total Taxable Sales (tax excluded)	\$ 10,617.25
Plus: Exempt Sales	2,000.00
Equals: Gross Sales/Total Sales	<u>\$ 12,617.65</u>

Sales Tax Equals: \$663.60

### Analyze Sales Tax Accrual Accounts

Analyze the tax accrual account (also called sales tax payable account) by comparing tax accrued to tax reported for the audit period. If differences exist, determine the reason for the difference, and if necessary, prepare a schedule and make an adjustment in the audit. In instances of larger companies, they may not have a separate accrual account for Massachusetts, but one all-inclusive account. Taxpayers may use other tax software to track sales by states, such as Vertex Tax Software. This type of software does provide detail tax by state and all state taxes should tie to the tax accrual account.

Differences may occur due to:

- Other credits in the sales tax accrual account (i.e., discounts);
- Holding tax liability on large sales for verification;
- Returned merchandise sales for which credit memos have not been recorded in the sales journals and/or tax accrual account; or
- Tax on taxable purchases being posted to the tax accrual account. This would make it a sales & use tax accrual and included as a use tax on the return.

Verify that credits such as those mentioned above are properly taken and supported.

Note: If the taxpayer does not maintain a tax accrual account, examine available summary records.

### **Analyze Debit Entries**

Analyze debit entries to determine if:

- Excess tax is being written off to a miscellaneous income account;
- Debit entries exist for bad debts, discounts, returned merchandise and refund claims. In many instances, the debit entries are manual entries in which only tax is debited and there may be no activity reflected in the sales journal or reflected in gross sales. Verify tax refund claims to determine if the customers have received them or qualify for a refund. Bad Debt reimbursement claims must be filed on Form ST-BDR or ST-BDR-Meals for sales on meals based on their fiscal year for federal tax purposes after 1999 for reimbursement of sales tax or use tax they have remitted to the Department of Revenue on accounts which are later determined to be worthless. An account is determined to be worthless when it is written off as uncollectible for federal income tax purposes under section 166 of the Internal Revenue Code. ; and " Debit entries are due to customers not remitting tax. Verify that the taxpayer has valid resale/exemption certificates to support them.

### **Fixed Asset Sales**

Examine Summary Records for the sale of fixed assets.

- Review general ledger fixed asset accounts for credit entries.
- Review Schedule D of the taxpayer's federal income tax return.
- Examine gain or loss accounts in the general ledger.
- Trace sales to journal entries, cash receipts and source documents to determine if tax was collected and reported or if the sale was exempt.
- Review depreciation schedule.
- Review fixed asset requisition or appropriation.
- Review accountant analysis of fixed asset accounts and transactions
- Review construction in progress account.

## **Deductions**

Verification of deductions is an important area of an audit; the deductions are the difference between total sales and taxable sales.

Deduction items include:

- Deductions supported by certificates;
- Deductions based upon sales destination;
- Deductions for sales and services specifically exempt by sales tax law and rules; and
- Deductions for adjustments to sales when sales tax has been paid. Adjusted for overpayment credit.

Normally, the review and reconciliation of deductions is made at the same time as that for total sales. Whenever feasible, adapt the audit procedure to the method used by the taxpayer to report deductions. The scope of the examination of deductions will depend on the conditions encountered. Deductions consist of total nontaxable sales claimed by the taxpayer. Most claimed deductions are supported by resale and exemption certificates and exemptions by law.

Conduct a detail examination if:

- Claimed deductions consist of relatively few items.
- All transactions can be examined in a reasonable amount of time.

Consider a sample examination if:

- Sales are numerous.
- Sales are of similar unit value.

Consider a stratified sample if:

- There is a large variation of price for units sold.
- There is only an occasional large sale.
- There are sales by product code.
- There are sales by department.

## **Certificates**

Deductions can be supported by various certificates that relieve the seller from liability for collecting the tax if the seller accepts the certificates in good faith.

The presentation and acceptance of resale certificates for sales of tangible personal property and taxable services, the requirements for the presentation and acceptance of

exempt use certificates for sales of tangible personal property and the rules for determining when sales of property or taxable services are sales for resale are outlined in Regulation 830 CMR 64H.8.1.

Types of certificates are:

- Resale Certificate ST-4;
- Exempt Use Certificate ST-12;
- Multiple Points of Use Certificate ST-12
- Department of State (88-3 AP621.3.1);
- Exempt Organization Certificate ST-5;
- Contractors Exempt Purchase Certificate ST-5C;
- Small Business Energy Certificate ST-13;
- Exempt container certificate ST-12EC;
- Exempt medical equipment ST-12B;
- Direct Payment Permit ST-14;
- Multi-Jurisdictional Certificates (accepted if the certificate contains the information prescribed by the Commissioner per statute and the corresponding Regulation 830 CMR 64H.8.1.

### **Resale Certificate**

A resale certificate is a document that is presented to the seller at the time of purchase, allowing the purchaser to buy the item tax-free. All blanks on a resale certificate should be completed. Pay particular attention to the description of the property being purchased to be resold. Compare the description on the resale certificate with the description on the sales invoice to determine if the certificate applies. In accordance with Chapter 64H section 8 (b), a certificate shall relieve the vendor from the burden of proof only if **taken in good faith** from a person who is engaged in the business of selling services or tangible personal property of the same kind as the services or property sold and who hold the registration at the time of purchasing the service or tangible personal property.

### **Exemption Certificate**

An exemption certificate is a document similar to the resale certificate. Exemption certificates describe the reasons claimed for exemption from the tax. Verify that the sale was to the entity claiming exemption rather than the individual connected with the Entity. In accordance with Chapter 64H, section(s) 8 (e)-(h) and Chapter 64I, section(s) 8 (g)-(j), the burden of proving that a sale of tangible personal property is exempt remains on the vendor unless the vendor accepts an exempt use certificate from the purchaser **in good faith who**, at the time of purchasing tangible personal property intends to use the property in a manner that qualifies for an exemption per Chapter 64H & Chapter 64I or who is unable to ascertain at the time of purchase whether the tangible personal property will be used in an exempt manner or used for some other purpose.

Certificates not taken in good faith are subject to sales and/or use tax in accordance with Chapter 64H & Chapter 64I of the MGL.

### **Agency Relationships:**

In accordance with DOR Directive 07-6, any person or entity, contractors included, may purchase items covered by Chapter 64H, sections 6 (r) and (s) without payment of tax provided that the property itself will be used in a manner specified by the statute. A showing of agency is no longer required for exemption under section 6(r) and section 6(s) and is limited to these two sections of the statute only.

For parties or entities purchasing items which may be exempt under Chapter 64H, sections 6(d) and (e), establishing an agency relationship will continue to be necessary if the party purchasing the items is not itself an exempt purchaser.

Following the general contractor rule, contractors are the consumers of tangible personal property that they purchase for use in the fulfillment of their contracts as specified in the contractor regulation, Emergency Regulation No. 12. However, construction contractors furnishing only construction management services or other "qualified services" with respect to a particular project may be eligible for the exemption per Chapter 64H, section 6(tt).

An exemption certificate is not required if the purchase is:

- Made by government agencies or a Massachusetts political subdivision.
- Exempt by statute.

### **Exemption Categories**

Exemptions from sales and use tax for specific items of tangible personal property and specific types of customers are provided under Chapter 64H, sections 6(a) through 6(ww). Each category needs to be studied to determine whether a full or partial exemption exists.

The following is a partial list of exemptions:

- Certain ships and vessels (64H, s.6(o));
- Sale of United States Flag (64H, s.6(w));
- Containers, Packaging Supplies and wrapping (64H, s.6(q));
- Food products (64H, s.6(h));
- Gas and Electricity (64H, s.6(i)(qq));
- Gold and silver (64H, s.6(ll));
- Governmental entities (64H, s.6(d));
- Medicine (64H, s.6(l));
- Interstate Commerce;
- Sales of Article of Clothing up to \$175 per article (64H, s.6(k));
- Newspapers and magazines, 64H, s.6(m));

- Property used for improvement of realty of an exempt organization (64H, s.6(f));
- Religious, educational and charitable or scientific (64H, s.6(e));
- Sales of Aircraft (64H, s.6(vv));
- Solar Energy Devices (64H, s.6(dd)); and
- ☐ Water (64H, s.6(i)).

### **Consular Tax Exemption Cards**

Effective June 1, 1988. The foreign diplomat should present his or her consular tax exemption card to the vendor when purchasing taxable merchandise.

A consular tax exemption card is issued by the U.S. Department of State, is not transferable, and may not be used by others, including spouses.

Vendors of Sales, Meals and Rooms Taxes:

Diplomats may obtain an exemption from these taxes by presenting a valid tax exemption card issued by the U.S. Department of State. As of January 1, 2002, State will issue only two types of exemption cards. The Blue stripe card exempts all purchases, both personal and official, from the sales tax. The Yellow stripe card exempts all purchases except as restricted on the face of the card. Certain exemptions may apply for the diplomat or for the mission that the diplomat represents such as all sales including hotel rooms; all sales except hotel rooms, all sales over an aggregate amount including hotel rooms and all sales over an aggregate amount with restrictions per the card.

The United States Department of State has also informed DOR that unless a diplomatic exemption card specifically states that the bearer is not exempt from the rooms tax, no rooms tax may be imposed. For audit purposes, the vendor must adhere to procedures detailed in AP 102.3.1 or AP 621.3.1:

### **Sales Tax Holiday Purchaser's Certification of Nonbusiness Use**

- Examine the taxpayer's certificate file. Are all transactions totaling \$1,000.00 or more that qualify for the sales tax holiday exemption listed to certify the items are being purchased for personal use and not for any business use?
- Check certification for:
  - Name of purchaser and address
  - Signature of purchaser
  - Phone number
  - Receipts attached

## Review of Certificates

Examine the taxpayer's certificate file. Is the certificate updated or current? (A taxpayer's number by itself does not make a certificate.)

- ☐ Check certificates for:
  - ☐ Name of purchaser and address
  - ☐ Valid taxpayer number (not required for the Exemption Certificates)
  - ☐ Signature of authorized person
  - ☐ Date
  - ☐ Description of items purchased
  - ☐ Description of purchaser's type of business.
  
- ☐ Check for certificates that are qualified.
  - ☐ Certificate specifies that only certain purchases are tax free or,
  - ☐ That all purchases are tax free with the exception of certain items.
  
- In deciding if a certificate is sufficient in content and if a seller acted in "Good Faith" in accepting the certificate, these questions should be considered:
  - Was the merchandise sold to a retailer who does not sell that particular type of merchandise? For example, a gas station presents a Resale Certificate (ST-4) to a vendor when it purchases a television.
  - Did the seller have knowledge that the particular item sold was to be consumed by the purchaser? Other factors: Was the purchaser registered at the time of purchase (especially resale)? Does the date on the certificate reflect this fact?
  
- Compare some sales invoices with certificates to verify sales claimed as deductions. Deductions should be supported by properly completed certificates.
- Do not schedule obvious sales for resale or sales to governmental entities.
- List all unsupported tax free sales on a schedule. Give copies of schedules to the taxpayer for review.
- Allow the taxpayer the time to review the schedules and acquire applicable certificates as required by statute under MGL, Chapter 64H & I, section (8). See discussion of Sixty-Day Rule below.

Note: Certificates are not required for the following:

- The United States government.
- Sales that are exempt by statute.
- Sales, which by their nature, qualify for a resale or other exemption, such as sales of bales of cotton to a clothing manufacturer.

## Sixty-Day Rule

If additional taxable sales are found which resulting from missing certificates, a Notice of Exceptions (60-day Letter) should be issued. This notice allows taxpayers 60 days from the date it is issued to provide any additional certificates.

In accordance with MGL , Chapter 64H, section 8 and by corresponding Regulation 830 CMR 64H.8.1, Resale and Exempt Use Certificates, vendors are permitted **only 60 days** following notice by the Commissioner "to provide an applicable resale and/or exemption certificate."

To enforce the law, it will be vital to have obtained a **signed** Notice of Exceptions evidencing the date the taxpayer was put on notice for all untaxed sales that were made on or after March 6, 1991.

The notice will contain the following information:

1. The date it was issued and read;
2. The specific date of expiration of the sixty days; and
3. Signature of both the taxpayer and auditor.

An entry should be made in the Audit WorkBench (AWB)-Case Log documenting the date of issue and whether or not the taxpayer signed or refused to sign the Notice of Exceptions.

Within the 60-day period, the taxpayer may produce a certificate that is missing or correct a certificate deficient in some manner.

It is important to note that the 60-day period **cannot** include the 30-day period given by the Notice of Intention to Assess. Accordingly, the notice should be sent to the taxpayer as early as possible in the audit process.

## Adjustments to Error Factor

Upon completion of the field examination and copies of the work papers listing the exception items are presented to the taxpayer along with a Notice of Exceptions, the following events can occur before the work papers are finalized:

- The taxpayer may present additional resale certificates (Form ST-4) for consideration and said transaction may be removed if the vendor has proven the certificate was taken in good faith.
- The taxpayer may present additional exempt use certificates (Form ST-12) for consideration and said transactions may be removed if the vendor **accepts the certificates in good faith.**
- The taxpayer may receive an adjustment on the work papers if it can be documented that a use tax was accrued and actually reported to the DOR on a

tax return by their customer. In instances where a customer proves that use tax was paid, the auditor shall issue a Vendor Notification to the taxpayer which informs them that this will not be allowed in the future.

Any of the above occurrences may warrant an adjustment to the work papers and applicable error factor calculation.

## **Referrals**

Some certificates accepted on audit due to a good faith acceptance may warrant referral for a follow-up use tax audit of the purchaser. Such referrals should always detail the underlying reasons for acceptance or non-acceptance and if not voluminous, a list of transactions identified. Referrals should be made using the Intradepartmental Field Audit Referral Form A-40C. (See Chapter 5 - Audit Completion: Documentation of Findings & Administrative Remedies).

## **Sales to Destinations Outside of Massachusetts**

The sale of tangible personal property that, under the sales contract, is shipped to a point outside of Massachusetts is exempt from tax as qualified under Chapter 64H, s.6(b) and as governed by 830 CMR 64H.6.7, Out-of-State Deliveries Regulation.

If a vendor is obligated to deliver to an out-of-state purchaser's address or to an interstate common carrier for such delivery, the sale is not taxable in Massachusetts. However, any taxable item brought into the state within six months of purchase for use, storage or consumption in Massachusetts is subject to the use tax under Chapter 64I, section 8(f).

Massachusetts sales and use tax law generally requires a business with nexus in Massachusetts to collect tax when it ships goods to a customer in Massachusetts on behalf of a retailer that is not required to collect the tax because it does not have nexus with Massachusetts. (Refer to Technical Information Release 04-26, Drop shipment provisions).

## **Cash Discounts, Coupons and Rebates**

The deduction for cash discounts, coupons and rebates is covered by Regulation 830 CMR 64H 1.4, Discount Coupon and Rebates. The following are general rules, but special circumstances may warrant additional research.

### **Discounts**

Cash discounts are allowed and taken at the time of sale are excluded from the sales price of tangible personal property upon which the sales tax is based.

Trade discounts allowed and taken at the time of sale on sales made to certain customers of a business are excluded from the sales price of tangible personal property upon which the sales tax is based.

### **Manufacturer's and Retailer's Coupons**

Generally, manufacturer's and retailer's coupons that entitle the retail customer to a reduction in sales price at the time of sale will be treated like cash discounts.

### **Scan Cards**

Manufacturer's and retailer's coupons in paperless form will generally be treated the same as paper coupons.

Coupons, certificates or vouchers issued in connection with "bundled transactions" are not manufacturer's or retailer's coupons any reduction in the amount paid by the retail customer will not be treated as a cash discount.

### **Coupons for Free Merchandise**

If a vendor offers a customer, upon presentation of a coupon, merchandise unconditionally free of charge, merchandise free of charge with the purchase of other merchandise or two items for the usual price of one, the sales price subject to tax is the amount the vendor charges the customer.

### **Returned Merchandise**

Returns of taxable merchandise are deductible if the following conditions are met:

- The original sale has been reported as taxable, and the taxable sale price less handling fee; and
- The entire sales tax is returned within 90 days from date of sale.

An handling or restocking charge does not affect the deduction allowed for returned merchandise.

### **Even Exchanges**

Repair, replacement or exchange of an item for an identical or similar item with no additional consideration from the retail customer is neither a rescission of the retail sale nor an additional sale as there is no additional consideration, thus no additional sales tax is due, even if the following conditions apply (Refer to Letter Ruling 03-8):

- The retail customer is unable to produce the original sales receipt or other verification of the date and place of the purchase; or

- The exchange or replacement takes place more than (90) days after the original retail sale.

### **Bad Debts**

Bad Debt reimbursement claims must be filed on Form ST-BDR or ST-BDR-Meals for sales on meals based on their fiscal year for federal tax purposes after 1999 for reimbursement of sales tax or use tax they have remitted to the Department of Revenue on accounts which are later determined to be worthless (Refer to Technical Information Release 00-3). Any bad debts deducted by the taxpayer on their regular return should be disallowed and assessed on audit.

### **Detailed Procedures For the Audit of Purchases**

Taxable purchases are taxable items:

- Purchased for personal or business use from out-of-state or in-state vendors on which no Massachusetts sales or use taxes were paid or accrued;
- Removed from a tax-free inventory for personal or business use;
- Purchased tax-free for an exempt use which are later used in a taxable manner;
- For personal or business use purchased from out-of-state vendors on which another state's sales tax was legally due and paid. Additional use tax is due when the items are brought into Massachusetts if the other state's tax is less than the sales tax due in Massachusetts. If tax is paid to an out-of-state vendor that was not legally due, credit is not allowed. In general, tax is not legally due in another state where the tangible personal property was shipped to Massachusetts. Credit for tax paid in another state will not be recognized where the purchaser is entitled to a refund or credit (Refer to Technical Information Release 03-1).
- Originally purchased for resale but subsequently put to business or personal use. Such purchases could be subject to a "use tax" or a "sales tax" depending upon whether an exemption certificate had been issued by the taxpayer to the vendor of the item(s). The auditor should determine, if possible, whether the item(s) were purchased from a Massachusetts vendor or a registered out-of-state vendor. See Chapter 64H, sections 8(d) and 8(h), and Chapter 64I, sections 8(e) and 8(j). Any assessments made based upon these sections should be cited on the Notice of Intention to Assess (NIA), the Supervisor's or Manager's Exit Conference Letter and on the work papers.
- Use Tax Exception: No use tax would be due in instances where items are purchased from an unregistered out-of-state vendor and temporarily stored in Massachusetts for subsequent shipment and use outside of Massachusetts (See Regulation 830 CMR 4H.6.7(3)(b)3).

## **Internal Control Questions to Be Analyzed and Evaluated for Taxable Purchases General**

### **Controls**

- Are all purchases routed through the purchasing department?
- Are any purchases made electronically via e-commerce or via the use of purchasing cards (P-Cards)? If so, identify the accounts affected and the process of accounting.
- What is the policy for issuing resale or exemption certificates? Is a certificate or declaration part of the purchase order?
- Are purchases made by cash? If so, what records are available to support these purchases? What kinds of purchases are made by cash?
- What is the taxpayer's definition of an asset? Does the Depreciation Schedule account for all capital assets? How are asset write-offs or retirements accounted for? What dollar amount is capitalized? Does the taxpayer manufacture equipment for use in the business? Are parts taken out of inventory to manufacture this equipment?
- How are inter/intra company transfers handled and booked?

### **Document Controls (Invoices and Purchase Orders)**

- What is the volume of purchases per month? Are there any seasonal purchases fluctuations?
- What is the control over purchase invoices? What department makes purchases? Who is authorized to make purchases?
- Are purchase invoices matched with purchase orders or receiving documents? Are purchase invoices numbered so that invoices can be processed by check or voucher number? Were there any changes to the numbering or filing system?
- How are purchase invoices filed (i.e., alphabetically, by invoice number, check number, voucher number, year, month or other)?
- Does the actual purchase invoice or order have the account code written or stamped on it?

### **Recording Process Controls**

- Does the taxpayer maintain an accrual account for use tax? Is location of the vendor and/or point of first use or storage incorporated in the coding?
- Are the purchases recorded in a summary journal?
- Is a cash disbursement journal, check register, voucher or warrant register available for the entire audit period?
- Is there an accounting manual and employee approval for determining distribution of invoice charges to general ledger accounts?
- Is the distribution of charges double-checked periodically?
- Is the accounts payable ledger balanced periodically with the general ledger control account?

- What controls are used to insure that all purchases and tax accruals were processed to the computer and recorded?
- How are credits for goods returned to vendors accounted for? How are damaged goods, back orders, trade-ins and inventory withdrawals accounted for?
- Are purchases made for employees cleared through the regular purchasing procedures? How are employee reimbursements accounted for?
- Are detailed records computerized? If so, would it be feasible to use computer audit techniques?
- What are the procedures and policies for computer coding for:
  - Account distribution?
  - State and local taxes?
  - Tax rates?
  - Taxable or exempt sales?
- Is the coding maintained and kept up-to-date? How are law changes and the items impacted by the change incorporated into the coding system?
- How are prior contract exemptions handled?

### **Audit Procedures For Taxable Purchases**

In examining taxable purchases, perform the following steps:

- Determine the taxpayer's knowledge of the law pertaining to taxable purchases including energy and telecommunication services;
- Evaluate the system of internal controls to determine reliability of the records;
- Determine how the taxpayer accounts for taxable purchases;
- Analyze the tax accrual account and compare to the reported tax. Evaluate all differences; and
- Review all pertinent books and records relating to taxable purchases (See Records to Examine).

The audit procedures used will depend on each specific taxpayer situation. The auditor will have to make some of the following decisions using auditor judgment:

- What expense accounts should be analyzed? The expense accounts should be evaluated based upon materiality and other audit circumstances (i.e., tax law change items, manufacturing exemptions, account code changes, etc.).
- What is the expense for services paid in connection with the purchase of taxable tangible personal property?
- Should expense accounts be sampled or detailed? Consider the volume and detail of the records, the completeness of the records and the cost/benefit and the relationship of the procedures involved.
- If sampling procedures are implemented, what sampling unit will be used (i.e., transactions, clusters, months, etc.)?
- Determine what the source of the data for the test will be. Will it be the general ledger detail for the accounts selected or will it be from accounts payable for the

accounts selected. If taken from accounts payable, the general ledger needs to be verified for the selected accounts to make certain that there are no purchases charged to the accounts that are not running through accounts payable.

- The sampling unit will depend on a couple of factors:
  - The taxpayer's record keeping method (i.e., how invoices are filed).
  - If records are missing, etc.

Once these decisions are made, audit procedures can be implemented.

- Examine source documents in detail or by sampling.
- Schedule all additional taxable purchases on which tax was not reported.

### **Records to Examine**

- Review the following records for unreported taxable purchases and services.
- General Ledger;
- Depreciation Schedule;
- Federal Income Tax returns for expenses and asset purchases or services;
- Tax accrual work papers; and
- Chart of Accounts. Look for:
  - Expenses involving tangible personal property, energy and telecommunications services;
  - Advertising (for promotional items, etc.);
  - Miscellaneous expenses;
  - Construction in progress - Auditors must be consistent when reviewing this account to make sure the date of taxation is reflective of their records (i.e., selecting the purchase date, invoice date, capitalization date or placed in service date;
  - Capital assets;
  - Demo Equipment;
  - Overhead expenses (office supplies, paper, etc.);
  - Repair and maintenance supplies;
  - Computer supplies and expenses;
  - Samples;
  - Operating supplies; and
  - Office and selling expenses.
- Purchase invoices. Look for:
  - Description of items purchased;
  - Invoices that include taxable purchases along with inventory items (i.e., display items, samples, etc.);
  - Unpaid invoices (accounts payable);
  - Charges for taxes; and
  - Account codes.
  - Note: Occasionally, an invoice may describe merchandise in technical jargon or be a catalog number. An examination of the related purchase

order or other documents may be necessary to explain the purchase invoice. The account code, department purchasing the items, the receiving document and the purchase order would help in identifying the product.

- Contracts, job files;
- Purchase Orders;
- Cash disbursement and purchase journals;
- Accounts payable and notes payable ledgers;
- Accounts payable distribution or voucher registers;
- Journal entries for inventory transfers;
- Journal entries for asset or expense transfers between related companies;
- Journal entries for asset or expense transfers from suspense accounts or centralized distribution points;
- Leases of assets or construction of assets by the taxpayer;
- Asset ledger/file; and
- Financing leases.

Tour the facilities to understand and examine assets maintained and possible manufacturing exemptions. Manufacturers are allowed certain purchase exemptions depending on how the purchases are used in processing and also their useful lives. Make inquiries of the purchase manager.

### **Verifying the 75% Requirements for the Exemptions of Certain Power Used on Manufacturing**

The exemption for electricity under MGL Chapter 64H, section 6 (i) states in part:

"The sales, furnishing or service of...(3)...gas, steam or electricity consumed and used directly and exclusively in an industrial plant in the actual manufacture of tangible personal property to be sold or in the heating of such industrial plant; provided that the exemption under this paragraph (3) shall only be allowed with respect to a metered building, location or premises at which not less than seventy-five percent of the gas, steam or electricity consumed at such metered building, location or premises is used for the purposes of such manufacturing or heating...."

In accordance with Technical Information Release 98-5, a safe harbor may be used as an alternative means to establish that it satisfies the seventy-five percent exempt use requirement for either gas, steam or electricity at a billed meter, or, if the taxpayer has internal meters that subdivide the power recorded at a billed meter, by reference to gas, steam or electricity recorded at each internal meter.

Under the terms of the 6(i) safe harbor, gas, steam or electricity used by the taxpayer to light or air condition a portion of the building, location or premises which the taxpayer performs actual manufacture will be deemed to be used "for purposes of the actual manufacture" and thus counted towards satisfaction of the seventy-five percent test.

Actual manufacture for the purpose of this safe harbor will be deemed to include short-term storage or transportation of in-process manufacturing goods (not including

raw materials or finished goods) when that storage or transportation takes place contiguous to the actual manufacturing activity. Any electricity used for purposes of research and development may be eliminated from the percentage calculation.

The taxpayer may claim the 6(i) exemption for all power recorded on each meter at which the seventy-five percent test is met. If a taxpayer is unable to demonstrate eligibility for the 6(i) exemption by measuring manufacturing activities attributable to a billed meter, and it has not subdivided the billed meter into one or more separate internal meters, it may claim the 6(i) exemption if it establishes that the billed meter is dedicated to an industrial plant in which seventy-five percent of the total cubic feet in such plant is used in the actual manufacture of tangible personal property to be sold.

The Commissioner may approve another reasonable method for computing the use of gas, steam or electricity at a billed meter to satisfy the seventy-five percent test provided that such method must be approved in writing by the Commissioner in the form of a Letter Ruling.

In order to determine the 75% requirement noted above the following guidelines should be considered:

1. During the initial stages of the audit a plant tour should be conducted. During this tour the number of meters should be noted. The auditor should ask if the taxpayer keeps internal meters that subdivide the power at the billed meter and obtain said records. If possible, the auditor should utilize the tour to make an initial determination of meters that monitor only exempt activities or taxable activities. The auditor should document this activity in the audit log.
2. If the meters monitor both exempt and taxable activities, the auditor's preliminary evaluation should take a common sense approach to determine if the exempt activity is 75% or greater. A worksheet should be developed showing how the auditor made such determination. For example, if the auditor utilized the cubic feet of the facility breaking down manufacturing areas and non-manufacturing areas, there should be a worksheet showing the computation and how the exempt or taxable determination was made.

### **Tax Accrual Reconciliation**

Some taxpayers have a use tax accrual account that summarizes use tax accrued on taxable purchases. Analyze the use tax accrual account and compare it to reported use tax history. Evaluate all differences. Schedule any unreported use tax. Evaluate all debit entries. This account could be a combination of sales and use tax liability account.

### **Purchase Categories**

Purchases can be divided into the following areas:

- Expense Items-Detail or sampling procedures may be used for expenses. Generally, transactions in this area are numerous and sampling may be

necessary. Schedule as audit adjustments any expense items on which taxes have not been paid to the vendor or reported to the DOR.

- Capital Assets-Generally, the volume of taxable purchases related to fixed assets is smaller than purchases associated with expense items and involves larger dollar amounts. This portion of the audit should be examined in detail. However, if there is a large volume of capital assets, sampling procedures could be utilized. If capital assets are sampled, the purchases must be shown to be consistent in occurrence and dollar value. In most cases, stratification is necessary.
- Construction-In-Progress (CIP)-All vendors in the CIP account must be verified as being resident or non-resident contractors. If non-resident contractors exist, the auditor should ascertain if a bond has been filed consistent with MGL, Chapter 64H, section 30A or 64I section 31A. If the non-resident contractor has not filed a bond, the taxpayer becomes liable for the tax on the cost of materials consumed on the job (Refer to DOR Directive 05-3).
- Items Withdrawn from Inventory-If a taxpayer maintains a tax-free inventory (items purchased with valid resale/exemption certificates) and withdraws items from this inventory for personal use, then taxes are due on the items withdrawn. Tax is based on the cost or fair market rental value.
- Examine the following:
  - Credits to inventory and purchase accounts (These items may be noted on zero dollar sales invoices);
  - Costs of goods section on federal income tax returns;
  - Intra-company transfers; and
  - Journal entries.

Discuss any inventory withdrawals with the taxpayer.

### **Tax Charged on the Invoice**

If a purchase invoice includes a charge for taxes, confirm that:

- Tax was paid on the entire taxable portion of the invoice;
- Taxes charged on the invoice were actually paid; and
- Taxes charged were for Mass. sales taxes or for another state. If, for

another state, check for the following:

- If correctly and legally paid to another state, verification of payment should be made.
- If taxes were erroneously paid to another state, then set up an adjustment for all Massachusetts taxes due. The taxpayer will have to go to the vendor for credit. If tax was erroneously credited to another state, then the taxpayer will have to go to that state for credit.

## **Taxes Not Paid to Vendor**

If taxes were not paid to the vendor as indicated on the invoice, confirm if the taxes were accrued and paid to the state.

- Check to see if any discounts were taken by the taxpayer.
- Double-check that the purchases and services are taxable items.

If tax is not accrued and reported, then make an adjustment for the applicable tax due.

## **Audit Referral Criteria**

If the vendor did not charge any tax and it appears that the vendor has representation in Massachusetts (i.e., vendor is located in Massachusetts, vendor has a salesperson who takes orders in Massachusetts, etc.) initiate a referral (Form A-40C) on the vendor unless it is known that the taxpayer gave the vendor a resale/exemption certificate.

## **Credits/Adjustments Allowed on Audit**

It is the responsibility of the auditor to ensure that the correct amount of tax due the Commonwealth has been reported. Accordingly, the auditor must take into consideration overpayments made by the taxpayer during the audit periods.

Prior to allowing credits on audit, the auditor must test specific accounts to verify the validity of the credit. The auditor must determine whether the overpayment is an unusual transaction or a common and systemic error in deciding if the credit would be Allowed for a specific period or projected through a test agreement to all the audit periods. Taxpayers should be instructed during the opening conference to identify the overpayments and provide the required documentation to substantiate the allowance of credits by the auditor. This documentation should be provided by the taxpayer within sixty days from the date of the opening conference. Extensions to the sixty day time frame must be approved by the supervisor.

The following guidelines should be followed by the auditor when verifying credits and overpayments:

- If the taxpayer imposed a sales tax on an exempt transaction, the auditor must ensure that the taxpayer has issued a credit or check to its customer before a credit can be allowed on audit. The auditor should also verify that the taxpayer has not previously received an abatement of tax on the transaction by checking MASSTAX. In addition, a taxpayer "NOTE" should be entered into the MASSTAX system to warn the Abatement Bureau about the allowance of the credit by the auditor.

- The auditor must verify that the credit was granted to the customer by examining canceled checks, credit memos, account statements or any other documentation which validates the transaction.
- If the taxpayer filed and paid use tax on exempt transactions, the auditor must allow a credit on audit, assuming that the taxpayer has not already filed an abatement claim. A taxpayer note should be entered into the MASSTAX system to signal a warning to the Abatement Bureau.
- The auditor must verify that the credit was not taken by the taxpayer on returns filed subsequent to the tax period on which the overpayment occurred.
- If the taxpayer paid sales tax directly to the vendor on exempt purchases or items resold, and the vendor remitted the tax on a ST-9 to the department, the auditor should instruct the taxpayer to request a credit from the vendor. The vendor should file an application for abatement for the overpayment of the sales tax. These types of credits are not allowable under audit of the purchaser even if the statute has been extended by the taxpayer.
- If a vendor claims that a sales tax deficiency assessment should not be made on taxable transactions, for which sales taxes were not imposed and there is no resale or exemption certificate, based on the fact that the purchasers have either paid a use tax directly or have been audited for sales/use taxes by the Commonwealth for the periods in issue, the auditor must perform the following tasks prior to allowing an adjustment:
  - Verify documentation and other evidence supporting taxpayer claim of tax paid by purchaser.
  - Provide taxpayer with completed Vendor Notification Form notifying that no adjustment will be made for future taxable transactions made on or after the date of vendor notification.
  - Management will maintain a file on vendor notification forms issued for use in future audits of such vendors.

**All credits/adjustments granted on audit must be approved by the auditor's supervisor or manager.**

### **Service Providers - Use Tax Audit Procedure**

The Audit Division has established the following procedures and guidelines for the auditing of service providers which may have made taxable purchases on which sales taxes were not paid to the vendor and use taxes are owing to the Commonwealth. If it is determined that a pattern misreporting and/or underreporting of use tax exists within a particular business industry, a more in depth review of the industry will take place based on information generated through an RFQ (request for quotation).

### **Registration**

- Service providers which are determined to have made purchases of tangible personal property on which sales taxes have not been paid and use taxes are owed will be required to register with the Department. Registration can be

completed through the DOR's web-based application, WebFile for Business (WFB), and can be found on line at <http://www.mass.gov/dor>.

### **Return Requirements**

- If the auditor determines a taxpayer will be required to file Business Use Tax returns (ST-10), the auditor will provide the audit work papers.
- The taxpayer will prepare a single annual return (Business Use tax return, Form ST-10) covering a twelve month period within the calendar year in which a use tax is due.

### **Penalty Waivers**

- Requests for the waiving of late file and late pay penalties will be considered in accordance with the Department's guidelines promulgated under Administrative Procedures 633 (AP 633). The taxpayer should make their request in writing to demonstrate that reasonable cause and not willful neglect existed in accordance with AP 633. The taxpayer's request should be submitted with the returns for consideration.

### **Audit Process Flow Chart**

Conduct Opening Conference Tour

Facilities

Analyze Reporting Categories on Sales/Use Tax Return Review

Taxpayer Reporting Methods

Review Internal Controls to Determine Reliability of Accounting System

Reconcile Recorded and Reported Sales (reconcile gross sales and taxable sales; sales tax and use tax using Taxpayer's return back-up)

Conduct a Preliminary Review of Taxpayer Records to Determine if records Reflect their Method of Accounting

Determine Whether Sampling Procedures/ Detailed Audit will be Employed

Determine Sampling Methods and Application of Sampling Procedures Apply

Audit Procedures and Complete the Following:

Examine Sales Records-Send 60-Day Letter to Taxpayer with Preliminary Sales Audit Work Papers

Examine Purchase (Expense) Records Examine

Fixed Asset Records

Complete Listing of Exceptions on the Audit Work Papers

Present Preliminary Audit Work Papers to the Taxpayer for Review Scan and

Attach Supporting Documentation in Audit WorkBench (AWB) Schedule an

Exit Conference to Review Audit Work Papers

## Chapter 8

### Meals and Room Occupancy Tax Auditing Procedures

#### Introduction

As with any other tax audit, the primary purpose of meals and room occupancy tax audits is to verify that the taxpayer has reported the correct amount of tax. In most tax audits, including meals and room occupancy tax audits, this is accomplished primarily through the review of the taxpayer's records. In many instances however, the auditor will need to utilize other means of verifications. Generally, this will include observation of the taxpayers operation and third party confirmation.

#### Administrative Details

##### Identifying Responsible Person(s)

In order to facilitate the collection of tax liabilities imposed on corporations and partnerships by MGL chapters 62B, 64G, 64H and 64I, auditors must identify the responsible person(s) who are liable for such trustee taxes pursuant to M.G.L. Chapter 62C, section 31A and Regulation 830 CMR 62C.31A.1.

The identification of responsible persons must be done for all trustee tax audits. Auditors must document in the audit narrative and Audit WorkBench (AWB)-Case Log the names of the individual(s) responsible for paying over the trustee taxes. This information must also be entered into the MASSTAX system under the taxpayer "NOTE" screen.

##### Bank Account Information

During the course of the examination, the auditor must gather the following information relating to the taxpayer's banking activity:

- Name of bank(s) in which the taxpayer has account(s); and
- Account(s) numbers.

If the taxpayer has more than three (3) accounts, the auditor must get the above information for the taxpayer's three primary accounts. The information must be noted in the audit narrative and documented in the MASSTAX system under the taxpayer "NOTE" screen.

##### Bankruptcy Information

When a taxpayer files the bankruptcy case, the automatic stay prohibits all of the taxpayer's creditors,

including the Department of Revenue, from taking any action to collect any debts or liabilities that relate to the time period before the Petition Date. During the course of the initial taxpayer contact, the auditor should ask the taxpayer if they are in bankruptcy. If the taxpayer is in bankruptcy, the auditor must obtain the following information and forward it to the Litigation Bureau's Bankruptcy Unit immediately:

- The location of the Bankruptcy Court;
- The Bankruptcy Court docket number (stamped on the bankruptcy petition); and
- The petition date (the date the bankruptcy case was filed).

The information must be noted in the audit narrative and Audit WorkBench (AWB)-Case Log to ensure the necessary steps are taken to contact the Bankruptcy Unit in a timely fashion.

**Note: Bankruptcy procedures are discussed in detail within Chapter 6-Specialized Audit Procedures of the Field Audit Procedures Manual.**

### **Records Retention**

Document all requests for records in the Audit WorkBench (AWB)-Case Log. If there are any problems in obtaining necessary records, a written request for those records should be sent to the taxpayer. **If the taxpayer claims not to have certain records that are required by the 830 CMR 62C.25.1: Records Retention Regulation needed for review, A Statement of Records Retention, should be executed and signed by the taxpayer and/or taxpayer's representative.**

### **Case Plan**

The Audit WorkBench (AWB)-Case Plan will be used to guide the progression of each case. The case plan is structured to allow for flexibility of workflow and is broken into primary tasks and subtasks. When all of the subtasks are completed within a certain primary task, it will automatically be recorded in Audit WorkBench-Case Log

### **Meals Tax Overview**

In accordance with M.G.L Chapter 64H, Massachusetts imposes a 6.25% sales tax on meals sold by or purchased from restaurants or any part of a store considered by Massachusetts law to be a restaurant. The tax is based on the sales price of the meal. In general, a food product commonly thought of as a grocery item is exempt from the sales tax on meals (See Regulation 830 CMR 64H.6.5: Sales Tax on Meals).

A meals tax "vendor" is anyone who sells meals that are subject to sales tax in Massachusetts. Vendors must add a 6.25% sale tax to the selling price of every taxable transaction and collect it from the purchaser.

A "meal" is any food and/or beverage that has been prepared for immediate human consumption and provided by a restaurant or restaurant part of a store. A meal includes food or beverages sold on a take-out or to go basis, whether or not they are packaged or wrapped, and whether or not they are taken from the premises of the restaurant.

A "restaurant" is any eating or drinking establishment, whether stationary or mobile, temporary or permanent, where food, beverages, or food products are provided and for which there is a charge. The list includes, but is not limited to following:

- Cafes;
- Cafeterias;
- Canteen trucks or wagons;
- Catering businesses;
- Cocktail lounges and bars;
- Diners;
- Dining Rooms;
- Hotel, motel dining rooms;
- Ice cream trucks and food stands;
- Lunch counters;
- Private and social clubs;
- Salad bars;
- Street wagons or carts;
- Taverns; and
- Vending machines that sell snacks or candy with a sales price of \$3.50 or more.

A "store" is any establishment that is not primarily engaged in the business of selling meals. In general, food products for human consumption sold by stores are exempt from the sales tax. However, any store that contains an area, section or counter where food product is prepared and meals are sold must charge a sales tax on those meals. Such a store is considered to have a restaurant part. Stores that may have a restaurant part include the following:

- Supermarkets;
- Grocery stores;
- Bakeries;
- Delicatessens;
- Convenience stores; and
- Markets.

### **Registration and Filing Obligation**

Return filings and tax payment methods depend on each entity's combined trustee tax liability for the preceding year. Businesses that registered on or after September 1, 2003, must file returns and pay taxes electronically, regardless of the amount of their annual tax liability.

Previously registered businesses with combined annual withholding, sales/use tax (including sales tax on meals and telecommunication services) and room occupancy excise liabilities of \$10,000 or more are required to file returns and make payments electronically. Previously registered businesses with a combined annual liability of less than \$10,000 may file paper returns, but are encouraged to file electronically.

### **Taxable Sales Price**

The sales tax is imposed on a meal based on the price of that meal. However, in certain instances, the sales price of a meal may include the tip, room rental or recreational admission charge as the basis which is subject to the tax. The following list includes situations where these items are considered taxable:

- Gratuities, service charges or tips added by the restaurant to the price of a meal are included in the taxable sales price if they are part of the consideration paid for the meal. However, separately stated gratuities, service charges or tips are not considered taxable if they are distributed in their entirety to those employees provided the service; and are accounted for separately in the taxpayer's records (See Regulation 830 CMR 65H.6.5(7)(a); and **Chatham Bars Inn, Inc. v. Commissioner of Revenue, No. F225093, April 29, 1998**);
- A room rental for the purpose of serving a meal, where the meal is provided by the operator of the room, is included in the price of the meal subject to meals tax, whether separately stated or not;
- Admission charges collected by a place of entertainment where food and/or alcoholic beverages are sold are taxable unless all of the following conditions are met: a ticket is sold and collected; the patron is not required to purchase any food or beverage, the charge is for admission only and does not include any payment for food or beverage and the admission charges are segregated from other receipts in the books and records of the place of entertainment.

### **Exempt Organizations - Sales of Meals**

Under M.G.L Chapter 64H, section 6(d) sales made to government organizations including the United States and its agencies, the Commonwealth of Massachusetts, and any of its political subdivisions and their respective agencies are exempt and prohibited from taxing under the Constitution or laws of the United States.

1. The sales of meals made to nonprofit organizations are exempt from taxation under Section 501(c)(3) of the Internal Revenue Code provided the following criteria are met:
  - The meals sold to the 501(c)(3) organization are used to further its exempt cause;
  - The exempt organization obtained Form ST-2 (Certificate of Exemption) from the Commissioner stating it is entitled to the exemption;
  - The exempt organization provides a properly completed Form ST-5 (Exempt Purchaser Certificate) and Form ST-2 attesting that the meals purchases are for an exempt use; and

- Sales of meals to persons, groups or organizations including caterers are exempt from meals tax when the purchases are made through or on behalf of an exempt entity in accordance with Regulation 830 CMR 64H.6.5(12)(b) or (d).
2. The sales of meals made by an exempt organization for fundraising purposes are considered exempt from the sales tax meals as casual and isolated sales provided that the sales of meals by the nonprofit organization are not made in the regular course of business. However, the Commissioner will consider the factors presented to determine whether the nonprofit organization: sells meals from a retail establishment that it operates; is required to hold a vendor's registration certificate in accordance with M.G.L. Chapter 64H, section 7; or the proceeds from the sales of meals constitute unrelated business income.

### **Certain Other Institutions and Organizations - Exempt Sales of Meals**

The following sales of meals by these institutions or organizations are considered exempt from the sales tax on meals in accordance with Regulation 830 CMR 64H.6.5 in the following instances:

- Health and day care facilities where all meals are both prepared and served by employees of the institution;
- Hot lunch programs for elderly persons through the school lunch program;
- Churches, Synagogues and other Religious Organizations where the meals are prepared and served by members of the organization, the meals are served only to members of the organization, the meals are served on the premises of the organization and any receipts in excess of necessary expenses are donated to the organization;
- Educational Institutions where the sale of meals are exempt to the student body only, and not the faculty or staff, provided the gross receipts are separated in the books and records of the educational institution;
- Summer Camps where the sales of meals are served by summer camps for children who are eighteen years old and younger or for developmentally disabled individuals; and
- Commercial Airlines where the furnishing of meals to commercial airline passengers whether the aircraft is in flight or on the ground is exempt from the sales tax.

### **Sales of Meals Sold Without Alcoholic Beverages**

The liquor license holder is presumed to be the vendor of all meals sold without alcoholic beverages at the licensed premises and is responsible for the collection and payment of the tax imposed by M.G.L. Chapter 64H.

A common victualler is a person licensed to sell meals without alcoholic beverages under M.G.L. Chapter 140. An innkeeper or common victualler is a vendor of all meals sold without alcoholic beverage at the licensed premises and is responsible for the collection and payment of the tax imposed by M.G.L. Chapter 64H.

## **Claiming the Bad Debt Reimbursement**

Massachusetts sales tax vendors who have remitted sales tax to DOR on accounts that are later determined to be worthless may file a claim for reimbursement with DOR. An account is determined to be worthless when it is written off as uncollectible for federal income tax purposes.

Reimbursements are paid annually without interest and may only be claimed on ST- BDR- Meals, Claim for Bad Debt Reimbursement. A claim for a vendor's prior fiscal year must be filed on or before the due date, including extensions, of the vendor's federal income tax return (or annual federal filing in the case of an exempt organization) for the prior fiscal year.

## **Vendors Are Not Allowed to Subtract Bad Debts from Gross Receipts**

Vendors must include in gross receipts for their Sales Tax on Meals Returns all sales for the period in which the sales occur, regardless of whether payment has been received.

Any vendor who recovers, in whole or in part, a bad debt for which a reimbursement has been received must include the recovered amount in the gross receipts amount of the appropriate sales tax return covering the period in which the recovery occurs.

## **Documentation to Submit with Completed Form ST-BDR:**

- If the federal income tax return is on extension, attach a copy of the appropriate federal application for extension form;
- Document each worthless sale and provide an explanation listing the date the sale occurred, the amount of the sale, the buyer's federal identification number, (if available), and all facts pertinent to the determination that the account is worthless; and
- Vendors who are unable to separately document the portion of each worthless account which represents taxable Massachusetts sales may calculate the reimbursement on an aggregated basis (Technical Information Release 92-2).

Note: If filing for Sales/Use Tax, as well as Sales Tax on Meals, complete two separate Forms (use the current period form only.)

## **Local Option Sales Tax on Meals**

### **Overview**

Chapter 64L, Local Option Meals Excise, was added to the General Laws pursuant to St. 2009, Chapter 27, section 60, which establishes the 0.75% local option sales tax on meals. The local option excise takes effect on the first day of a calendar quarter following thirty days after acceptance by the city or town or the first day of the calendar

quarter designated by a city or town. The local option meals tax can be effective October 1, 2009 or later (See Technical Information Release 09-13).

However, a combined state and local tax of 7.00% is added to the total price of the meal, which constitutes the state tax of 6.25% and the local tax of 0.75% for those cities and towns, which adopt the local option sales tax on meals. Reimbursement for the local meals tax must be paid by the purchaser to the vendor. The meals tax vendor must file returns and pay the local option meals excise at the same time and in the same manner as the sales tax on meals is due in accordance Chapter 64L, section 2(a).

### **Room Occupancy Tax Overview**

In accordance with M.G.L. Chapter 64G, Massachusetts imposes a room occupancy excise tax of 5.7% on the transfer of occupancy, for \$15 or more per day, of any room in a bed and breakfast establishment, hotel, lodging house, or motel for a period of 90 days or less. In addition, each Massachusetts' city and town is permitted to levy a local room occupancy excise of up to 4.5% and 6.5% in the City of Boston, pursuant to the recently enacted legislation in St. 2009, Chapter 27, sections 51 and 52 effective on or after October 1, 2009, where each city or town votes to accept the new rate in accordance with Chapter 64G, section 3A (See Technical Information Release 09-13).

Generally, you are responsible for collecting and remitting this tax if you are an individual or business operating a hotel, motel or lodging house, or private club offering sleeping accommodations and the relationship between you and the occupant is not that of landlord and tenant.

### **Registration and Filing Obligation**

Return filings and tax payment methods depend on each entity's combined trustee tax liability for the preceding year. Businesses that registered on or after September 1, 2003, must file returns and pay taxes electronically, regardless of the amount of their annual tax liability.

Previously registered businesses with combined annual withholding, sales/use tax (including sales tax on meals and telecommunication services) and room occupancy excise liabilities of \$10,000 or more are required to file returns and make payments electronically. Previously registered businesses with a combined annual liability of less than \$10,000 may file paper returns, but are encouraged to file electronically.

## **Exempt Establishments**

Under M.G.L. Chapter 64G, section 2, the following room rentals are exempt from the room occupancy excise tax:

- Lodging accommodations at federal, state or municipal institutions;
- Lodging accommodations at religious, charitable, educational or philanthropic institutions;
- Privately owned and operated convalescent homes or homes for the aged, infirm, indigent or chronically ill;
- Religious or charitable homes for the aged, infirm, indigent or chronically ill;
- Summer camps for children eighteen years of age or under or developmentally disabled individuals; provided; however, that such summer camp which offers its facilities off-season to individuals sixty years of age or over for a period not to exceed thirty days in any calendar year shall not lose its exemption hereunder; and
- A bed and breakfast home. A "bed and breakfast home" is a private owner-occupied house where three or fewer rooms are rented, a breakfast is included in the rent and all accommodations are reserved in advance.

## **Federal Government Employees**

If a federal employee or other federal government officer, including a United States Military employee, is acting within the scope of his or her official duties for the federal government and in that capacity stays in a hotel, motel or other place of public accommodation, that occupancy is exempt from room occupancy excise. The exemption is available whether the federal government pays directly for the room, or the employee pays for the room and is later reimbursed.

## **Government Entities and Non-Profit Organizations**

The occupancy of rooms by employees of any state, its agencies or political subdivisions, and the occupancy of rooms by employees of charitable organizations are subject to tax, whether or not such employees are on official business and whether such employees or their employers made payment for the occupancy.

## **Worthless Accounts**

Massachusetts operators of bed and breakfast establishments, hotels, lodging houses, or motels who have remitted room occupancy excise tax to the Department of Revenue (DOR) on accounts that are later determined to be worthless may request an abatement of the room occupancy excise paid on such worthless accounts. Accounts determined to be worthless are written off for federal income tax purposes as an uncollectible account under section 166 of the Internal Revenue Code. The abatements are issued without interest and must be filed on Form ABT, Application for Abatement, on or before April 15th of each year for worthless accounts in the prior calendar year.

Businesses required to file electronically must file an Application for Abatement online at [mass.gov/masstaxconnect](http://mass.gov/masstaxconnect). If you are not required to file electronically or are otherwise unable to file a dispute online, file an abatement using [Form ABT](#).

Note: The operator must document each worthless rental and provide an explanation listing the date the rental occurred, the amount of the rental, the occupant's federal identification number (if available), and all facts pertinent to the determination that the account is worthless.

### **Convention Center Financing Overview**

The Convention Center Act provides for construction and financing of convention centers in the Commonwealth. See St. 1997, Chapter 152. Under the Convention Center Act, a 2.75% Convention Center Financing (CCF) fee is imposed on the transfer of room occupancy by any operator of a hotel, motel or other lodging establishment in Boston, Cambridge, Springfield or Worcester.

The CCF fee is in addition to the state room occupancy tax rate of 5.7% and the local option room occupancy tax rate of 4% in effect for those cities. The Convention Center Act authorizes the Department of Revenue (DOR) to administer the 2.75% CCF fee as a tax under the provisions of M.G.L. Chapter 64G, the room occupancy excise. Effective October 1, 2001, the 2.75% CCF fee was extended to the transfer of room occupancy by an operator of a hotel, motel or other lodging establishment in West Springfield or Chicopee. The 2.75% CCF fee is collected and remitted in the same and at the same time as the room occupancy rate on Form RO-2F (See Technical Information Release 01-15).

The legislation imposes a Convention Center Financing fee and three CCF surcharges, all effective January 1, 1998. The legislature granted authority to the Commissioner to administer the CCF surcharges as though they were taxes and make them subject to all the tax administration provisions of Chapter 62C (See Technical Information Release 05-1).

The surcharges include the following:

1. A 5% CCF surcharge on the purchase price of a ticket for any water-based sightseeing, tourist venue or entertainment cruise or tour, and for any land-based sightseeing, tourist venue or trolley tour conducted partly or entirely within Boston. The surcharge is collected and paid by the operator of any tour or cruise and reported to the DOR on Form CCF-ST;

2. A \$10 CCF surcharge on any vehicle rental contract in Boston. The surcharge is collected and paid by the vendor operating a vehicle rental establishment and reported to the DOR on Form CCF-VR; and
3. A \$2 (per day) CCF surcharge on any vehicle that parks in any parking facility built in Boston, Springfield or Worcester in conjunction with the projects authorized by this legislation. The surcharge is collected and paid by the operator of a parking facility built in conjunction with a convention center facility and reported to the DOR on Form CCF- PF.

**Although there are three Convention Center Financing surcharges, a meals tax auditor is generally responsible for auditing the surcharge on sightseeing tours.**

### **Preliminary Analysis**

The auditor should research, as much as possible, every aspect of the taxpayers operation before making contact with the taxpayer. The auditor should first review the MASSTAX historical tax information on the taxpayer. Corporate or personal income tax returns must be reviewed in order to document and reconcile the amount of gross receipts reported for income tax purposes with the amount of gross receipts reported for meals tax purposes. An observation of the taxpayers operation should be undertaken with findings being recorded onto the Observation Report Form. NYNEX Yellow Pages and newspapers advertisements may also provide valuable information and should be included in the audit package if relevant to the audit findings. The inspection of city/town records should be considered in verifying the taxpayer's licensing authority and facility capacity if warranted.

An auditor's observation of a taxpayer's business is useful in developing an understanding of the operation and its accounting in the books and records subject to examination. The hours of operation, the size of the establishment, the number of cash registers used, and whether the taxpayer is operating with an open drawer or ringing in "no-sales" are factors to be considered in testing the accuracy of the taxpayer's records and serve to support the auditor's determinations and findings on appeal. Discoveries made through observations of the taxpayer's business operations and practices must be fully documented in the Audit WorkBench (AWB)-Case Log.

### **Opening Conference**

A field audit begins with an opening conference. In addition, the auditor is expected to secure additional detail about the taxpayer that will be used to conduct the audit more efficiently and identify issues for review. Prior to the opening conference, the auditor will prepare a list of questions to be addressed which will provide for an understanding of the operation and records which will uncover any problem areas prompting the auditor to raise additional questions when appropriate during the interview. The auditor should have the taxpayer sign a Statement of Record Retention in cases where the taxpayer has stated that he has not maintained the requested records. The taxpayer or taxpayer's representative should be asked to explain or provide the following:

- The reporting method utilized.
- The step-by-step process by which the information is obtained and summarized to prepare the return. (This information includes the records used to prepare the return.)
- Any work papers used to prepare the return. (These should be checked for completeness and whether they include all areas subject to tax.)
- General Ledger accounts that have been used by the taxpayer in reporting. (Check for related accounts when the Chart of Accounts is reviewed.)
- Changes in personnel who prepared the return. Obtain the name and position of anyone who prepares a specific portion of the return.
- Menus, brochures and other relevant information covering the audit period.
- Resale/exemption certificates for tax-free sales.
- Items included in deductions and taxable purchase.
- Unusual areas (i.e., changes in reporting method, etc.).
- If the reporting method has been changed, check the different methods used and document the changes in the Audit WorkBench (AWB)-Case Log.
- What items the taxpayer is claiming as deductions.
- All categories of revenue.
- Billing & collection procedures for all sources of revenue through the accounting system; including cash and charge sales and credits.
- The self-assessment or the accrued tax liability procedures.
- Purchasing procedure for inventory, supplies, expenses and fixed assets.
- Accounts payable process including receiving and approving for payment, account distribution, returns, checks and remittance advice as well as cash pay outs.

### **Return Analysis**

Meals taxes are reported on a monthly basis on Form ST-MAB-4. The reporting categories on these returns are as follows:

- Gross Receipts From the Sales of Meals
- Total Charged From Tax Exempt Meals
- Total Taxable Receipts
- Tax

Room Occupancy taxes are reported on Form RO-2 or Form RO-2F. The line items on these returns are as follows:

- Total Rents
- Taxable Rents
- State Tax Due
- Local Tax Due (varies according to city or town)
- CCF Tax Due
- Total Tax Due

Where the taxpayer has maintained all of the proper records necessary, the standard procedures utilized on a Meals or Room Occupancy Tax audit are quite simple. These procedures are intended to verify the accuracy of the line items on the returns.

However, in instances where the taxpayer has failed to maintain adequate records, the auditor must utilize alternative methods to reach a conclusion about the amounts reported by the taxpayer on its returns. Regulation (830 CMR 62C.25.1) was promulgated by the department to indicate all the records required to be maintained by the taxpayer.

Restaurants are for the most part, cash businesses. Cash businesses have always presented taxing authorities with problems in ensuring that the proper receipts and taxes are being reported. The documentation of all sales as well as the proper recording of purchases and other disbursements provide the evidence that the auditor needs to verify the correct amount of taxable sales and taxable income.

### **Examination of Records**

Generally, the records that must be examined:

- Sales Journal
- Purchase Journal
- Cash Register Receipts
- Guest Checks
- Room Folios and Guest Cards (Room Occupancy tax audits)
- Bank Statements
- Income Tax Returns
- If the business is a closely held business, the personal income tax returns as well as the D-Tax account of the owner or owners should be reviewed. The auditor should check for low net income in comparison to large mortgage interest and real estate tax expense. Also, the RMV information for the owner or owners should be reviewed to determine if the income can support their lifestyle.

In performing the audit review, the auditor should reconcile the information available in these records with the tax returns. Standard procedures should be followed in this review, but these procedures should be adapted or expanded depending upon the particulars of the individual case.

### **Daily Sales Journal**

The daily sales journal should be tested for accuracy. Based upon a review of the amounts reported, four months should be selected for this test. The four months should be from different seasons, and different years if at all possible. The columns of the daily sales journal should be added and compared with the amounts which have been reported on the tax return. If any errors are noted, this test should be expanded. A work paper detailing this review should be prepared by the auditor and attached to the AWB

Case.

Once the column totals have been verified, the auditor should compute the tax due for each period of the audit and compare this amount with the taxpayer's reporting of meals or room occupancy tax due. A work paper should be prepared and attached to the AWB Case to document this review.

### **Cash Register Tapes**

Three different periods of cash register tapes should be selected for review. Ten consecutive days should be chosen from each period selected. The periods selected should be included in the months selected for the test of the daily sales journal, one from each of the months.

When reviewing cash register tapes, the auditor should compare the register tape totals to the daily sales journal for each day, noting any multiple ring-outs for the day. Is the total an "x" rather than a "z"? Are there transaction numbers or time of ring-outs which may indicate missing transactions? Is there an unusual number of "no-sales" being rung into the register? Are there more "z outs" than are indicated in the daily sales journal?

The auditor should unroll the tapes to check for the above. Is there a tape to coincide with all the registers noted in the auditor's observation? If any inconsistencies are noted in this review, this test should be expanded. Any problems regarding these areas will lead to the determination that the taxpayer's records are inadequate. A work paper must be prepared and attached to the AWB Case to document this review.

### **Guest Checks**

Ten days should be selected for this review. The days selected should be chosen from the days selected for the cash register tape review. The checks should be added and compared with the cash register tape totals and a work paper should be prepared and included in the audit package. The auditor should also review the guest checks in greater detail, noting any problems observed. Are the checks numbered? Are there any checks which are missing? How many waitresses are using the checks and does the number of waitresses coincide with the observation made by the auditor? What menu items are being ordered? This may become important later in the review. Are checks used for all sales? What about bar sales or takeout orders? The auditor should make specific reference about any observations regarding the guest check in the AWB-Case Log. If problem areas are noted, the test should be expanded.

### **Room Folios / Guest Cards**

The review of room folios/guest cards is a step which should be undertaken in room occupancy tax audits. A minimum of ten days should be selected for review. The room folio/guest cards should be traced and reconciled with the daily room rental report. A work paper should be prepared to document this review.

## **Bank Statements**

The bank statements of the business should be reviewed and all deposits scheduled. Any returned checks and cash pay-outs should be reconciled and the schedule must be attached to the AWB Case.

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## **Income Tax Returns**

A work paper should be prepared to compare and reconcile any differences noted between the gross receipts reported by the taxpayer on the Income Tax Return (1120, partnership or Schedule C), the total net bank deposits and the gross receipts reported on the meals tax and room occupancy returns filed for the period. This work paper must be attached to the AWB Case.

## **Purchase Journal**

Totals from the purchase journal should be added and compared with the amounts reported on the taxpayer's corporate or personal income tax returns. Any inconsistencies should prompt a more extensive review. The auditor should take note of the name of the vendors and the type of product they sell. Third party verification should be undertaken if there is any suspicion that purchases may be incorrectly accounted.

This suspicion is usually due to the auditor's prior observation.

For example, are all menu items reflected in the taxpayer's purchasing? If the taxpayer has an extensive seafood menu, verified through the examination of guest checks, and there is little in the way of seafood purchases, there is a problem. Perhaps these purchases are paid in cash and not recorded. Unusual patterns of purchasing may also be noted and further inquiry could detect additional unrecorded purchases. Any of these factors will shed doubt on the adequacy and correctness of the taxpayer's records.

## **Summary**

The auditor must reconcile information available from the taxpayer's records with the line items in the tax return. Because of the inherent problems associated with cash businesses, the auditor must not simply take these records at face value. The auditor must determine if the taxpayer's records are adequate and reliable through observation of the taxpayer's operations and records. If it is determined the records maintained by the taxpayer are inadequate, the auditor may need to use alternative methods to determine the correct taxable receipts.

## **Alternative Methods**

A taxpayer's records may appear to be complete and correct, when in fact, the taxpayer could be skimming cash from the business and substantially under-reporting the tax liability. The taxpayer could have two cash register tapes which are being posted into the daily sales journal. Cash amounting to the total of these two tapes is deposited into

the checking account. The total of these deposits agree with the amounts reported on the taxpayer's meals or room occupancy tax and income tax returns. The auditor notes the taxpayer's mark-up and it appears to be low. Through observation, the auditor may have noticed that there was another cash register in operation or that there were more employees than indicated in the taxpayer's payroll records. By properly documenting the observation, the auditor has proven that the taxpayer's records are inadequate and this leads into an alternative method to determine the correct sales made by the taxpayer.

If, after conducting a preliminary review of a taxpayer's records, it is determined that the taxpayer's books, papers and other data are inadequate to calculate the proper amount of tax, the auditor may utilize alternative methods to determine the amount of tax liability due.

Alternative methods used by the Audit Division may include bank deposit analysis, mark-up, third party information and any other method that is reasonably calculated to reflect taxes due in light of the facts and circumstances.

### **Bank Deposit Method**

An analysis of bank deposits is used to test the relationship between cash receipts and recorded gross receipts. Use of this method is of value when auditing companies selling predominately taxable items.

There are two methods of estimating gross receipts on the basis of bank deposits:

- Where records of deposits are available for the entire period they should be scheduled for that period.
- Where records of deposits are available only for a portion of the audit period, a percentage of error should be computed and then applied to recorded or reported sales for the remainder of the period.
- The record of cash deposits must be adjusted for the following types of transactions that affect total receipts:
- Increases or decreases in the gift certificates sold and gift certificates redeemed accounts.
- Increases: Cash expenditures and withdrawals from cash receipts before bank deposits are made.
- Decreases: Deposits representing receipts from sources other than sales, i.e., loans, re-deposits of NSF checks, rental income, etc.

If the taxpayer has a record of cash pay-outs, the totals by months should be scheduled. If no such record exists, pay-outs for merchandise sometimes can be estimated by examining the check record or canceled checks to determine which types of merchandise are paid by bank checks.

Credits for loans and increases in capital must be supported by documentary evidence in the form of canceled notes, letters from banks, savings bank books showing withdrawals, etc. The nontaxable receipts must be traced to bank statements to verify

the amount and date of those deposits. Where vending machines are on the premises, copies of statements of settlement from the operators can be used to verify income from these sources. Lottery income and transfers between accounts are also sources of deposits that must be considered in a deposit analysis. The auditor should be alert for evidence of bank accounts for which the taxpayer has not produced statements or deposit books.

### **Mark Up Method**

Mark-up is the difference between gross sales and the cost of goods sold. It is the amount that the goods are marked up in price. Generally speaking, the mark-up is referred to in terms as a percentage of cost of goods sold. To determine this mark-up percentage you would divide the sales price by the cost of goods sold to arrive at your mark-up percentage. Thus, an item with a cost of \$1.00 that is sold for \$3.00 would have a mark-up percentage of 300%.

A mark-up is the amount added to cost to obtain the sales price, and generally is referred to in terms of percentages. The percentage of mark-up (MU) is computed by dividing sales (S) by cost of goods sold (COGS):  $S/COGS = \% \text{ of MU}$ . Businessmen often discuss gross profit in terms of percentages based on sales, but seldom discuss mark-up based on cost. Care should be exercised by the auditor to make certain he is on common ground with the taxpayer when discussing gross profit and mark-up percentages.

Areas of importance in the use of a mark-up method include:

- The determination of total purchases;
- Beginning and ending inventory;
- The segregation of purchases between departments or types of merchandise having the same general level of mark-up;
- Self-consumed merchandise;
- Shrinkage of inventory; and
- Inventory adjustments.

### **Verifying Total Purchases**

Where a record of purchases is available, the monthly or quarterly totals should be tied-in for the entire audit period. These should be proved and the recorded purchases compared with purchase invoices on a test basis to insure that total purchases have been recorded. In many cases, however, a record of purchases will not be available.

Under those circumstances, the purchase invoices should be scheduled for a test period. The auditor should conduct sufficient tests to ensure that all purchase invoices are on hand. Recommended procedures are:

- Scrutinize accounts payable for names of vendors with no supporting invoices.

- Ascertain names of brands and types of merchandise carried by a personal inspection of the stock and compare with invoices submitted by the taxpayer.
- Examine canceled checks or check stubs.
- Examine record of cash paid outs.
- Examine vendor's monthly statements for completeness of invoices.

When the auditor is doubtful that all purchase invoices are available, purchases for a test period should be obtained from a representative number of vendors. If it is found that the taxpayer's records are incomplete, some or all of the purchases should be obtained from all vendors records. This procedure should be used in extreme measures only as it is usually very time consuming.

### **Segregation of Purchases**

If there are widely different mark-ups in the various departments or types of merchandise, the purchases, if possible, should be segregated into classes to facilitate the application of appropriate mark-ups. Before adopting this procedure, however, the auditor should make sure that the purchases can be so segregated. If they cannot, an average weighted mark-up applicable to all purchases should be computed.

### **Adjustment for a Change in Inventory**

The auditor must be cognizant of a change in the taxpayer's beginning and ending inventory. A decrease in inventory will increase goods available for sale. Therefore, the sales per mark-up will be greater than the amount determined by marking-up the taxpayer's purchases.

Conversely, an increase in inventory will reduce goods available for sale and the subsequent amount of sales determined by marking-up purchases.

When breakdowns of the taxpayer's inventories are not available a weighted average amount should be discussed with the supervisor and applied to the change in the taxpayer's inventory.

### **Self-Consumed Merchandise**

The recorded cost of goods sold should be reduced by the cost of merchandise consumed by the taxpayer, if the self-consumed quantities are supported by the taxpayer's records.

### **Shrinkage of Inventory**

In order to recognize the fact that food can spoil or liquor can be spilled a 10% reduction to sales calculated by the mark-up method must be allowed. This allowance is also sufficient amount to cover complimentary meals, complimentary drinks and undocumented employee theft. When the taxpayer claims shrinkage of more than 10%, he must substantiate the amount. This substantiation may consist of reports from

regularly employed security guards, private detective agencies or similar service firms as well as losses computed through sales and inventory reconciliation.

Other substantiation may include the following documents:

- Police reports;
- Insurance claims and settlements;
- Inventory (for fire loss and large theft claims; and
- Type, size and location of store and availability of inventory for pilferage.

When a greater than 10% merchandise shrinkage allowance is given, it should be set out as a separate item.

### **Calculation of Mark-Up**

The accuracy of an audit based on purchases marked up to selling prices depends principally upon two factors; the correctness of cost of sales and the accuracy of the calculation of mark-up. The cost and selling price must be known to compute the mark-up.

This procedure contemplates the auditor will make an actual examination of menus, price tags, price stickers, or any other method used to inform the customer of the unit sales price.

If all items sold are marked up by approximately the same percentage, a straight average may be used. However, if the mark-up on the several classes of purchases varies materially, a mark-up should be computed for each of the classes or a weighted mark-up is computed. The weighted mark-up is usually based on dollar volume of purchases although the units purchased and units sold method may be used to an advantage in certain instances. The most commonly used methods of computing mark-ups are given below in order of preference:

- Weighted average; purchases of one or more purchasing styles;
- Segregation of classes of merchandise; or
- Average of selected items.

Mark-up for periods outside of the audit period may be used when current records are so incomplete as to prohibit establishment of a current mark-up.

Mark-up computations vary in the degree of detail due to the type of establishment being audited, the number of menu items and the records that are available. Generally, the more detailed the computation, the more accurate the computation will be.

Mark-up computations for food sales can be easily performed on an establishment with a limited menu, such as a pizza restaurant, hamburger and hot dog stands, fish & chip restaurants, etc. The more extensive the menu however, the more difficult the

computation becomes. In these instances, several menu items should be chosen and analyzed to determine an average mark-up factor for food items.

All adjustments made before or after computing a mark-up, such as spillage, theft and spoilage should be fully explained and easily understood. The auditor must remember that a hearing officer has no prior knowledge of the case. Once a mark-up becomes somewhat complex or varies from the usual, great care should be taken to explain the method in as simple a way as possible.

### **Flow Through of Adjustments to Gross Receipts**

Any changes to gross receipts as a result of a meals tax audit will usually trigger an adjustment to the taxpayer's corporate or personal income tax returns. These adjustments should be addressed with the taxpayer at the closing conference and the Notices of Intention to Assess for both meals and corporate or personal income taxes should be issued simultaneously. In this way, any appeals can be heard at the same time.

When examining the income tax returns of the business, the auditor should review the deductions claimed by the taxpayer on the 1120 return or schedule C in order to detect items which may be questionable. Items such as unusually high advertising expense or loans from stockholders may raise audit issues.

The auditor should also be alert to detect possible use tax issues. A new restaurant, or one which has undergone renovation, may have purchased furniture and equipment without paying a sales tax. The taxpayer's depreciation schedule should be reviewed to detect such purchases. Generally, unless the taxpayer is a large chain or one of the larger restaurants in the state, use tax on expense purchases would be minimal. In any case, the auditor should document in the audit narrative that this issue has been addressed.

As a standard procedure, the review of a taxpayer's compliance with all other taxes must be performed by the field auditor. Compliance with the filing requirements for withholding, corporate and personal income taxes must be addressed in the audit narrative.

### **Business Segments**

There are many different types of restaurant operations and each type has its own set of peculiarities with which to deal with. The following will point out some of these peculiarities and how the auditor may approach the audit.

#### **Function Halls & Caterers**

- Wedding Announcements (Newspapers)
- Gratuities

- Exempt Functions (Documentation)

### **Pizza Shops**

- Records (inadequate)
- Purchases
- Alternative Methods (boxes, rolls, flour purchases)

### **Donut Shops**

- Nontaxable sales (over 6)
- Alternative Methods (coffee mark-up, bags, boxes)

### **Bars & Taverns**

- Records (inadequate)
- Verification of purchases
- Alternative methods (mark-up of costs)

### **Room Occupancy Tax Issues & Convention Center Financing Issues**

The most frequent issues encountered in room occupancy tax audit are addressed by the following DOR Directives (DD), Technical Information Releases (TIR), Letter Rulings (LR) and Court Cases:

- Rentals for more than 90 consecutive days (See **Lowney v. Commissioner, 67 Mass App Ct. 718 (2006)** and TIR 07-2);
- Airline Rentals (LR 81-108 as modified by Lowney and TIR 07-2);
- Rentals by government employees (LR 80-79 & LR 82-18);
- Rentals by foreign diplomats (DD 88-3);
- Mandatory service charges/gratuities (830 CMR 64H.6.5(7)(a), Chatham Bars Inn, Inc., ATB Docket No.F225093(1998) and DD 99-6 for Room Occupancy;
- Forfeited deposits (LR 85-32);
- Recreational facility charges (LR 86-2 & TIR 89-7);
- Rooms rented to Department of Public Welfare (LR 86-5);
- Complementary rooms (DD 06-7);
- Charitable organizations (LR 81-90 & LR 82-18); and
- Resale of telecommunications services (830 CMR 64.1.6, TIR 99-2 and TIR 91- 1).

### **Function Halls & Caterers**

Meals tax audits of function halls and caterers involve several areas not normally encountered in routine meals tax audits. Most function halls and caterers structure their pricing policy so that in addition to the menu price of a meal, a gratuity and/or service

charge is imposed. It is extremely important to ascertain whether or not these charges are paid out, in their entirety, to the service personnel. If any portion is kept by the taxpayer, or is used to subsidize the payroll, the entire charge is taxable. A review of the payroll records is usually necessary to make this determination (830 CMR 64H.6.5).

Another item to be aware of involves charges for the use of a room in which to hold the function. If a separate charge is made for the room and the room is used to serve food, the room rental charge is subject to meals tax. If the purpose of renting the room is for a meeting and only light refreshments are served in the room (coffee, Danish, fruit, etc.), then the room rental charge is not taxable (See LR 79-26, 84-66, 830 CMR 64H.6.5).

These taxpayers are usually where an auditor will encounter the greatest number of exempt sales. The auditor must verify that any sales exempted by the taxpayer are substantiated with the proper certificates. M.G.L. now requires "good faith" in the acceptance of all exempt certificates. The certificates should be reviewed to insure that they are filled out completely and signed. Any incomplete certificates or certificates that are not signed or were not accepted in good faith should be rejected. If the taxpayer does not have certificates for all exempt sales, a sixty day notice should be issued to limit the time that will be allowed for the taxpayer to secure certificates (See LR 84-66, 84-73, 830 CMR 64H.6.5).

"Package Plans" are another area frequently encountered during audits of these types of taxpayers. The important thing to remember about package plans is if the items included in the package are mandatory, the entire package price is subject to meals tax. Package plans usually are wedding packages including flowers, invitations, entertainment, food, liquor, etc. Again, if the customer cannot pick and choose separately priced items that they want, but rather must accept the package in total, the entire charge is subject to meals tax (See 830 CMR 64H.6.5).

If the auditor suspects that all sales have not been reported, it might prove worthwhile to review local newspapers for wedding announcements indicating that the reception was held at the taxpayer's establishment. Once a list has been established, it can be compared to the function invoices or reservation book to determine if all of the parties were reported.

## **Bars & Taverns**

When the proper records are maintained, these are some of the easiest audits to perform due to the limited number of menu items. The problem is that these types of establishments are the ones that most frequently maintain little or no records. When an auditor encounters inadequate records, he/she will be forced to use an alternative method to determine taxable sales. In addition, if it appears that records have been maintained but the sales are still subject to suspicion (mark-up too low or too high, sales too low for size of operation, etc.) an alternative method may still need to be employed. The important thing to remember is case history has shown that if records are

maintained, an auditor has to prove that the records do not accurately reflect the sales of the business before an alternative method can be utilized. One important way to overcome the records is through personal observation (please refer to the section on preliminary analysis).

During observation, an auditor should try to determine the following:

1. **Number of Bartenders on Payroll** - The auditor should note how many bartenders are working. Does the bartender ring up all sales, even for the waitresses? Is more than one register used?
2. **Pouring Practices** - Are the bartenders free pouring or are they using a measure? Do they use a pouring gun?
3. **Sources of Other Income** - Does the bar contain video games, pool table, etc.? If there are machines, are many patrons using them? Does the bar sell anything besides food and liquor such as shirts, hats, etc.?
4. **Door Charges** - Does the bar charge an admission charge? If they do, is a receipt of any type given? Do the customers get anything besides entertainment for the admission charge such as free food or drinks? (See TIR 78-4, 830 CMR 64H.6.5(7)(d)).

Once the decision has been made to use an alternative method, one of the first things to do, is to verify that the purchases shown by the taxpayer are correct. The Audit Division now has a data base containing liquor wholesaler information and supervisors can provide the auditor with the taxpayer's purchase information. Once accurate purchase figures are secured, a mark-up audit should be performed.

The purchases should be recorded by category. The categories should reflect the various selling prices used by the taxpayer. For example, domestic bottled beer, imported bottled beer, draft beer, call liquor, top shelf liquor, etc., will all have different selling prices. Purchases for each price category should then be marked-up by the mark-up attributable for that price category. In order to calculate an accurate mark-up, an auditor must have the correct selling prices and serving sizes.

At the opening conference, the auditor should have the taxpayer supply the selling prices for the audit period and should have the taxpayer sign a certification so that at a later date, the taxpayer cannot argue that incorrect prices were used. The taxpayer should also be asked what his/her serving sizes are. Claims that drinks contain more than 1.5 ounces of liquor should be verified by the auditor.

For example, the following purchases were made by the Taxpayer: 20 cases of Budweiser, 25 cases of Bud Light, 30 cases of Miller Lite, 12 cases of Becks, 15 liters of vodka, and 22 liters of rum. The total cost of all of these purchases was \$3,500. The Taxpayer does not have any records with respect to beginning and ending inventory and is an outstanding filer for corporate excise. Consequently, the figures with respect to beginning and ending inventory are not available. Therefore, we assume all purchases were sold. Under that assumption, sales are computed in the following

manner: First you would compute total beer sales. To do so, you total the number of cases of each type of beer purchased. You would multiply that by 24 to get the total bottles. From that you subtract a 10% waste factor. The resulting number would be the bottles of beer available for sale. Since we have assumed that all purchases were sold, you multiply the number of bottles available for sale by the selling price for that brand.

The following table shows the calculation:

Type of Beer	# of Cases	Total Bottles	10% Waste	Units Available	Selling Price	Sales
Bud	20	480	48	432	\$ 3.00	\$1,296.00
Bud Light	25	600	60	540	\$ 3.00	\$1,620.00
Miller Lite	30	720	72	648	\$ 3.00	\$1,944.00
Becks	12	288	28.8	259	\$ 3.50	\$ 906.50
<b>Total</b>						<b>\$5,766.50</b>

Sales of liquor would be computed in a similar fashion. You would determine the number of bottles of each type of liquor that was purchased. You would then multiply the number of bottles purchased by the number of ounces in a bottle to get total ounces purchased. Again, you would apply a 10% waste factor to arrive at ounces available for sale. Absent any evidence to the contrary, we assume that 1.5 ounces of alcohol are used in each drink. Therefore, you divide the available ounces by 1.5 to arrive at the number of drinks. You multiply the number of drinks for that type of alcohol by its respective selling price.

The following chart shows a simple calculation for two types of alcohol. While there may be many different types of liquor, the calculation is the same. You just need to know the type of alcohol, the brand, and the respective selling price.

Liquor	# Bottles	Ounces/Bottle	10% Waste	Ounces Avail	Total Drinks	Selling Price	Sales
Vodka	15	33.875	50.8125	457.31	305	\$4.00	\$1,220.00
Rum	22	33.875	74.525	670.73	447	\$4.00	\$1,788.00
<b>Total</b>							<b>\$3,008.00</b>

Totaling the projected beer and liquor sales you arrive at total sales of \$8,774.50. This would then be compared to reported sales for the same period. If reported sales were less the discrepancy would be the additional taxable sales. If the Taxpayer sold wine and keg beer additional calculations would have to be made. However, the calculations are similar to the liquor sales whereby you compute the total drinks available and multiply the result by the respective selling price.

Mark-up audits can become very time consuming so an auditor should be confident that a real problem exists before proceeding in this direction. If a mark-up appears to be too low, the auditor should ensure that there is no legitimate reason for the low mark-up before proceeding with a mark-up audit. If no reason for the low mark-up can be found, the auditor should proceed, but only after having substantiated that the records are inadequate as outlined in the sections on preliminary analysis and alternative methods.

## **Pizza Shops**

The pizza business has changed in the last few years with the increase of large chains opening up in all areas. The days of the family owned pizza shop on every corner are diminishing and the audits conducted in this type restaurant have also changed. The meals tax filed by the chains has been found to be generally accurate due to the many internal controls established by the home office or franchises. Their requirement of complete and accurate records along with the internal audits which they conduct has nearly eliminated the need for in-depth audits on this segment of the pizza business.

However, not much has changed with the individually owned pizza shops especially in regards to the problems which are commonplace in cash businesses. As previously discussed, a complete review of all records would be conducted including register tapes, guest checks, sales journal, purchase invoices, and Schedule C or Corporate tax returns when available.

The problem arises in conducting these audits when there is an absence of records for the examiner to review and an alternative method must be utilized. The most common method would be to verify the purchases made by the taxpayer during the audit period and applying the appropriate mark-up ratios to arrive at taxable sales. Unlike other establishments where the total purchases, whether they are food or liquor, would be marked-up, the pizza shop audits have the advantage of basing the projected sales on specific purchases of supplies, etc.

The auditor should contact the taxpayer's suppliers to obtain the purchases made of pizza boxes, pizza rounds and grinder rolls. Once these amounts have been secured in writing, adjustments would be made to reflect the opening and closing inventory of the paper products. An average price would be assigned to the pizzas and grinders, based on the taxpayer's menu, and multiplied by the amounts purchased. The pizza rounds are placed in each box to go, but are also used to serve those pizzas which are consumed on the premises. For this reason, both purchases of these paper products must be analyzed to determine the in-store and take out sales.

The grinder roll purchases, which are usually made by cash and records not always kept by the supplier, may have to be determined during the initial audit interview. The auditor should instruct the taxpayer to keep the delivery slips from that point on to arrive at the normal amount purchased for a certain time period. There will be a pattern of deliveries made taking into account that larger orders are received on Fridays and Saturdays to cover the weekends when deliveries are not usually made. Again adjustments must be made to allow for bread purchases which are not sold. It should be

noted that taxpayers will state that excess rolls are thrown away but it is common practice to freeze them for future use. In addition to grinder sales, many pizza shops sell Syrian sandwiches which can also be determined by the corresponding bread purchases.

There are other sales which the auditor should be aware of such as pasta dishes, salads and fish and chip dinners. These items usually make up a small percentage of the total sales but must be taken into consideration. Again the containers that the salad is sold in and the amount of pasta and fish which is purchased will be utilized in determining the accuracy of the sales reported.

The last area to review is that of drinks sold in the pizza shop. The sale of any size beverage which is consumed on the premises is taxable, the sale of unopened original containers 26 ounces or more to go and beverages sold through a vending machine which cost less than \$3.50 are both exempt.

Assume the following facts: A taxpayer purchases 3,000 large pizza rounds, 500 small pizza rounds, 1,000 sub rolls, 500 wraps, 250 salad containers, and 1,000 cans of soda. Unlike a beer and liquor markup, you do not know the exact selling price related to these various purchases. A pizza round could equate to cheese, pepperoni, or some other combination pizza. All of the pizzas have different selling prices. From discussions with the Taxpayer, possibly your observation, as well historical knowledge you should determine the quantity/percentage of each item being sold. From that you can determine the average selling price of each item. For example, if cheese pizzas represent 50% of all pizza sales than the average selling price of pizza would be weighted 50% to the price of a cheese pizza. Thus, assume a price of a large cheese pizza is \$8.00, pepperoni \$9.00 (represents 25% of large pizza sales), and other is \$10.00 (represents 25% of large pizza sales). The average price of a large pizza would be \$8.75 (\$8 times 50% plus \$9 times 25% plus \$10 times 25%). You would then multiply the 3,000 large pizza rounds by \$8.75.

The following table shows the calculation of gross sales:

Item	Purchases	10% Waste	Quantity Sold	Avg. Price	Sales
large pizza	3,000.00	300.00	2,700.00	\$ 8.75	\$23,625.00
small pizza	500.00	50.00	450.00	\$ 5.25	\$ 2,362.50
Subs	1,000.00	100.00	900.00	\$ 5.75	\$ 5,175.00
Wraps	500.00	50.00	450.00	\$ 5.50	\$ 2,475.00
Salad	250.00	25.00	225.00	\$ 5.25	\$ 1,181.25
Soda	1,000.00	100.00	900.00	\$ 1.00	\$ 900.00
<b>Total</b>					<b>\$35,718.75</b>

With the exception of the cans of soda, you would have to determine the average selling price of each item. As the variety of items within a category increase, you might want to take an average of the five most popular items within that category. You also might

have to adjust the price for any documented specials. After accounting for any price adjustments, the average selling price is multiplied by the units sold for that category to arrive at projected sales. The difference between projected sales and reported sales would be the discrepancy.

The procedure listed above is necessary to arrive at sales when sufficient records are not available and should also be utilized to verify the sales when there are records. The taxable sales figures determined by the examiner will not be exact, but in the absence of records our reasonable and fair calculations will be upheld.

### **Notification of Inadequate Records**

After the auditor has calculated taxes due based on the use of alternative methods, the auditor is required to provide the taxpayer with a written statement supporting the auditor's determination of tax liability Notification of Inadequate Records Form.

The notification must be issued upon completion of the audit and prior to the exit conference or the issuance of a Notice of Intention to Assess.

The notification should be hand-delivered whenever possible, and mailed (certified) otherwise. It must be issued to the person designated by the taxpayer to make decisions regarding the conduct of the audit. The designee should be determined during the opening conference.

All notifications given to the taxpayer should be attached in the Audit WorkBench Case.

### **Noticing Requirement**

The form should include sufficient detail for the taxpayer to fully understand the methodology used by the auditor. This usually requires a general reference to the methodology and specific references to the taxpayer's unique circumstances. The notice must include the following information:

- The name of the taxpayer, as shown in the records of the Department;
- The taxpayer identification number;
- The type of tax or taxes assessed;
- The tax period or periods under audit;
- A brief statement indicating the reason(s) for using the alternative methods of determining liability for tax;
- A brief description of the records, if any, upon which the such or alternative method was based;
- A brief description of the alternative method used;
- A brief statement specifying how the alternative method was used to determine tax liability; and
- Any additional information the Commissioner deems appropriate.

## Chapter 9

### Corporation Excise Tax Procedures

#### 9.0 Auditing Corporate or Financial Institution Excise – Overview and Purpose

The object of a Massachusetts Chapter 63 tax audit is to verify that the taxpayer has reported and paid the correct amount of tax for the years under audit review. This procedure reviews various aspects of corporate taxation and suggests various steps to be taken to gather and review information during the audit. This procedure may not be cited as legal authority but includes references and links to statutes, regulations, other public written statements and various ATB and court decisions.

This procedure outlines audit guidelines and techniques applicable to the vast majority of corporations that file returns in Massachusetts. Most corporations doing business in this state are taxable under [Chapter 63 § 39](#), with definitions and related provisions affecting the calculation of the excise set forth in §§ 30 - 52. Financial Institutions (generally, banks and entities in competition with banks) pay tax under [Chapter 63 § 2](#), with definitions and related provisions set forth in §§ 1 – 2B. The mechanics of the calculations are generally similar but there are some important differences in the details, notably in the deductions allowable, apportionment rules and the availability of credits. This chapter is divided into sections that address audit procedures common to both types of taxes, with subsections that highlight the differences in the calculations for financial institutions from those applicable to general business corporations. In addition to the general procedures, there are special sections that address audits of S Corporations taxable under [Chapter 63 § 32D](#) (or [§ 2B](#) if the entities are [Financial Institutions](#)) and Security Corporations taxable under [Chapter 63 § 38B](#). This procedure does not attempt to address audits of insurance companies. In many cases, a corporate affiliated group will be engaged in a unitary business, in which the case the group will be subject to combined reporting under Chapter 63, § 32B. The procedures to be applied in these instances are discussed in more detail in chapter 10.

Each section of this procedure suggests steps/questions/lines of inquiry that may be appropriate to the audit in process. These are not exhaustive. The techniques discussed are among the most common, but in order to perform an audit of a corporation that is taxable on its net income, auditors, for example, must be prepared to review both state and federal guidance. Also, the suggested procedures are not to be performed in every case. Auditors are expected to use good business judgement in determining what items on the return to review, how closely to review these items and how to craft follow-up questions after the initial data responses are received and analyzed. Auditors should also consult with their supervisors in making these decisions. In addition, requests for information and the analysis of applicable facts should be customized as necessary to the circumstances of the case.

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## 9.1 Overview of MA Corporate Taxation

Business entities that are either doing business in or exercising their charter in Massachusetts are, with limited exceptions, subject to entity level taxation on their income if they are taxable federally as corporations.

Under the IRS “check-the-box” rules, an unincorporated business with two or more members is allowed to elect to be taxed federally as either a corporation or to otherwise be treated as a partnership. Also, an unincorporated association with a single member may elect to be taxed federally as a corporation, or be otherwise treated as a “disregarded entity” (and in some cases be treated as a branch or division of its owner for federal tax purposes). For tax years beginning on or after January 1, 2009, the filing status for business entities in Massachusetts must conform to their filing status for federal tax purposes. See [830 CMR 63.30.3](#).

A business entity's federal “check-the-box” election or default federal classification will apply for Massachusetts corporate excise purposes. If a taxpayer made an entity classification election under the “check-the-box” rules using federal Form 8832 it will apply that classification to determine its Massachusetts tax and filing status. A taxpayer that has not made a federal election will apply the default federal classification, which will also apply for purposes of determining Massachusetts tax status. No separate Massachusetts election is required or permitted. Detailed rules for federal entity classification which (also apply to M.G.L. c. 63) are found at [26 CFR 301.7701-1 through 301.7701-3](#).

Most corporations doing business in this state are taxable under [Chapter 63 § 39](#); definitions and related provisions affecting the calculation of the excise are set forth in §§30 - 52. Certain corporations, based on their activities or other characteristics, may not be required to pay the § 39 Corporation Excise. [M.G.L. c. 63 § 68C](#) lists the types of corporations that are not required to pay the excise that applies to general business corporations, most of which are taxed under other provisions of the general laws (e.g., Financial Institutions pay tax under [Chapter 63 § 2](#)).

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### 9.1.1 MA Corporate Excise - Income and Non-Income Measure

[M.G.L. c. 63, § 39](#) imposes an excise on general business corporations that are doing business in Massachusetts. For tax years beginning on or after January 1, 2009, [M.G.L. Chapter 63, § 30](#) defines “business corporation” to include any corporation, or any “other entity” as defined in section 1.40 of chapter 156D that is classified for the taxable year as a corporation for federal income tax purposes.

The Massachusetts corporate excise is measured in one part by income (the “income measure”) and in one part by property (the “non-income measure”). The income measure and the non-income measure are added together in order to determine a taxpayer’s corporate excise liability. The income measure of excise for a business corporation is calculated as a percentage of the taxable net income that is allocated or apportioned to the Commonwealth. A corporation’s net income is calculated using its gross income as determined under the Internal Revenue Code less the deductions allowable under the Code with certain modifications as referenced in [M.G.L. c. 63 § 30](#). Corporations with income from business activity that is taxable both in Massachusetts and in one or more other states are required to apportion this income (as opposed to allocating the income), using one or more factors (the portion of property, payroll and/or sales of the business that are in Massachusetts relative to the property, payroll and/or sales of the business more

generally). See [M.G.L. c. 63, § 38](#). This calculation determines the income of the corporation derived from business carried on in Massachusetts.

The non-income measure of excise for a corporation is calculated as a percentage of the net book value of either (i) the value of its taxable tangible property located in the Commonwealth and not subject to local taxation (if the taxpayer is determined to be a “tangible property corporation”), or (ii) its taxable net worth (if the taxpayer is determined to be an “intangible property corporation”). See [M.G.L. c. 63, § 30.8-11](#). The non-income measure of excise is also affected by apportionment [, since the base of the non-income measure may be either the value of tangible property located in the Commonwealth (less property already taxed locally) or on taxable net worth, which includes an allocation of assets based on the current year's MA apportionment percentage.

The corporate excise may be offset by tax credits and/or increased by credit recapture taxes (in the latter case with respect to certain credits granted and used in prior years but not fully earned by the taxpayer). There is a statutory minimum amount due for each corporation subject to the business corporate excise. See [M.G.L. c. 63, § 39\(b\)](#). A special credit is allowed to a new corporation during the 1<sup>st</sup> three years of its existence (it must not be 50% or more owned by another corporation) that is applicable only to the minimum excise. See [M.G.L. c. 63 § 38DD](#).  
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### **9.1.2 Manufacturing and R&D Corporations ([M.G.L. c. 63 § 42B](#))**

Business corporations may apply to the Department of Revenue to be classified as manufacturing corporations or R&D Corporations. A corporation may be classified as both a manufacturing corporation and a R&D corporation at the same time if its activities qualify it under both tests. While classification in either case may confer tax benefits on these corporations, they remain subject to the Corporation Excise imposed by [M.G.L. c. 63, § 39](#).

#### ***Manufacturing Corporations***

*Manufacturing* is defined as the process of substantially transforming raw or finished materials by hand or machinery, and through human skill and knowledge, into a product possessing a new name, nature and adapted to a new use. For classification purposes, the corporation must be engaged in manufacturing within Massachusetts and those activities must be *substantial* in comparison to its other activities in this commonwealth. Rules for determining whether the corporation is engaged in manufacturing (with numerous examples) and whether that manufacturing is substantial are set forth at [830 CMR 58.2.1 \(6\)](#).

Manufacturing classification confers upon corporations a local property tax exemption for machinery (see [M.G.L. c. 59 § 5\(16\)\(3\)](#)), something which can be a substantial benefit. Auditors should be aware that the local property tax exemption is only allowed for corporations classified as such by the commissioner. The Department is required to annually publish a “corporate list” for use by local assessors (a list of corporations that identifies those that meet the requirements of a manufacturing corporation). The Department has established procedures to accept and review applications from corporations seeking manufacturing classification. Either the corporation or the local assessor can appeal a corporation’s classification status as noted in the “corporate list” for a given year directly to the Appellate Tax Board on or before the 30<sup>th</sup> day following the listing. If an audit determines that a corporation that was previously classified as a manufacturing corporation should not have been so classified, a referral should be made to have that classification revoked prospectively.

Certain other tax benefits are available to corporations that are engaged in manufacturing within Massachusetts. A taxpayer is not required to apply for classification to receive these benefits provided its activities meet the threshold for classification. An audit determination that the taxpayer did not meet the standards may be applied retroactively to any open year with respect to these benefits. The following additional tax benefits/attributes potentially apply (note that whether a corporation's manufacturing activities are *substantial* is to be determined under [830 CMR 58.2.1](#)).

- A limited sales/use tax exemption under [M.G.L. c. 64H §§ 6\(r\) and 6\(s\)](#) applies if the corporation is doing any manufacturing in Massachusetts. This expands to include similar property used directly and exclusively in research and development if the corporation's in-state manufacturing activities are substantial.
- The investment tax credit under [M.G.L. c. 63 § 31A](#) is available if the corporation is manufacturing in Massachusetts and its in-state manufacturing is substantial.
- A corporation engaged in substantial manufacturing, **including** manufacturing activities in other states, uses 100% of the sales factor in calculating its apportionment percentage under [M.G.L. c. 63 § 38](#).

A more detailed discussion of manufacturing is provided in the apportionment section of this procedure.

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### ***Research and Development Corporations***

*Research and Development* is defined as experimental or laboratory activity having as its ultimate goal the development of new products, the improvement of existing products, the development of new uses for existing products or the development or improvement of methods of producing products. For purposes of qualifying as a research and development corporation, a corporation must meet the following three requirements:

- It must be engaged in research and development in the commonwealth.
- Its principal activity in the commonwealth must be research and development.
- It must meet either a receipts test (2/3 of its Massachusetts receipts must be derived from R&D) or an expenditures test (2/3 of its Massachusetts expenditures must be allocable to R&D activities).

Rules for determining whether or not the corporation is engaged in R&D and whether or not it qualifies as an R&D corporation are set forth at [830 CMR 64H.6.4](#).

A corporation that has, after filing a formal application, been classified as an R&D corporation under § 42B is eligible for a local property tax exemption under [M.G.L. c. 59 §5\(16\)\(3\)](#) if and only if that locality has adopted the exemption for R&D corporations (cities and towns have a choice about allowing the exemption for R&D corporations; they are required to offer the tax break to a manufacturing corporation).

Certain other tax benefits may be available to corporations that qualify as R&D corporations, but those are based on actual activities and not a formal classification:

- A limited sales/use tax exemption under [M.G.L. c. 64H §§ 6\(r\) and 6\(s\)](#) applies to property used directly and exclusively in research and development if the corporation meets the requirements to be an R&D corporation under § 42B.

- The investment tax credit under [M.G.L. c. 63 § 31A](#) is available if the corporation qualifies as an R&D corporation under § 42B if and only if it meets the receipts test (2/3 of its Massachusetts receipts must be from R&D). A corporation that qualifies based only on the expenditures test is not eligible for § 31A credit.

As with manufacturing, an audit determination that the taxpayer did not meet these standards may be applied retroactively to any open year.

As previously noted, a corporation that qualifies as either a Manufacturing Corporation or a Research and Development Corporation under [M.G.L. c. 63 § 42B](#) is eligible for certain tax breaks but remains subject to the Corporation Excise imposed by [M.G.L. c. 63, § 39](#).

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### **9.1.3 Domestic International Sales Corporation (“DISC”) ([M.G.L. c. 63 § 38G](#))**

A DISC is a corporation formed to take advantage of federal tax benefits for businesses making export sales (per [M.G.L. c. 63 § 30.14](#), a DISC for Massachusetts tax purposes must meet the requirements of IRC § 992(a)(1)). If the DISC is wholly owned by another corporation, the parent must include all of its income, assets and liabilities on its own return for the year. A wholly owned DISC is defined in [M.G.L. c. 63 § 30.15](#) as “a DISC, all of whose outstanding shares, excluding director’s qualifying shares, are owned by a single corporation either directly or indirectly through other corporations all of whose shares are owned directly or indirectly by such corporation.”

If the DISC is not wholly owned by another corporation (i.e. the owner of an S Corporation has established a DISC as a sister corporation to take advantage of the lower federal rate on dividends), the DISC is treated as a separate corporation under M.G.L. c. 63.

**A DISC whose income is not included in the return of its parent under the rules of § 38G (as discussed above) is subject to the combined reporting provisions of [M.G.L. c. 63, s. 32B](#).**

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### **9.1.4 S Corporations ([M.G.L. c. 63 § 32D](#))**

Corporations which qualify as S Corporations under the Internal Revenue Code are required to file as S Corporations in Massachusetts. S Corporations that would otherwise be business corporations are subject to the Corporation Excise but the income measure is calculated at a reduced rate.

Subchapter S of the Internal Revenue Code (Sections 1361 through 1379) allows stockholders of certain corporations to unanimously elect "S Corporation" status. As a general proposition, an S Corporation does not pay a federal corporate income tax (with limited exceptions for corporations that have accumulated undistributed earnings and profits from activities prior to S Corporation election). As such it is characterized as a “pass-through” entity. Income is taxed directly to shareholders as it is earned, whether or not the S Corporation actually distributes any money or property to them. In limited circumstances, a tax is imposed federally at the corporate level (this generally applies to passive investment income and/or built in gains - see IRC sections 1374 & 1375).

The Code provides that a corporation may be a "qualified S corporation subsidiary" (a "QSUB") under IRC § 1361 if 100% of the stock is owned by an S Corporation. The QSUB is treated for tax

purposes as if it had dissolved into its parent on the last day of the year and all items of income and expense belonging to the QSUB are attributed to the S Corporation parent. The QSUB does not file a federal income tax return. For taxable years beginning on or after January 1, 2009, a QSUB does not file a Massachusetts corporate excise return and it does not pay a tax under M.G.L. c. 63. All of its income, deductions, credits, activities etc. are taken into account by the parent as if it were a division of the parent.

Massachusetts S Corporations are subject to the same procedures as general business corporations in calculating their non-income measure of the corporate excise, and S Corporations are eligible to earn and use credits and are subject to recapture tax in the same manner as a C Corporation. Certain credits allowable to taxpayers under either chapter 62 (the personal income tax) or chapter 63 (such as the Brownfields credit) *may be* passed through to shareholders when earned as part of their distributive share (this decision is irrevocable). Credits that are passed through to shareholders that cannot be applied in a taxable year for which a carryover is allowed may be carried over and applied against the shareholder's personal income tax liability in succeeding taxable years. Those credits carried over by shareholders may not be claimed by the S corporation in subsequent years. Similarly, credits which the corporation *does not* pass through to shareholders for which carryover is allowed may be taken against the corporation's excise tax liability in subsequent years but credits carried over by the corporation may not be distributed to shareholders in subsequent years. Credits earned by an S Corporation that are only available under chapter 63 may be used to offset the excise of the corporation and may not be transferred to the shareholders. S Corporations are subject to the \$456 minimum excise.

The income measure of excise for an S Corporation is determined by calculating taxable net income (including any income or factors from any QSUB) as if it were a C corporation, but that income is then divided based on whether the income is taxable at the entity level under the Code: Category One Income is the income of an S corporation that is taxable at the entity level under the Code; for example, built-in gains of an S corporation taxable under Code § 1374, or excess net passive income of an S corporation that has accumulated earnings and profits for a taxable year that has gross receipts more than 25% of which are passive investment income taxable under Code § 1375. Category One income is taxed at the rate that would apply if the S corporation were a C corporation. [M.G.L. c. 63, §§ 2B\(a\)\(1\)](#) and [32D\(a\)\(i\)](#).

Category Two Income is the income of an S corporation that is not Category One income. This income is subject to the income measure excise only if the total receipts of the S corporation (and certain affiliates of the S corporation) are \$6 million or greater.

- (1) when total receipts for the taxable year are \$9,000,000 or more, the rate is calculated by subtracting the rate applicable to Part B taxable personal income ([M.G.L. c. 62 § 4\(b\)](#)) from the rate applicable to business corporations [M.G.L. c. 63 § 39\(3\)](#); and
- (2) when total receipts for the taxable year are at least \$6,000,000 but less than \$9,000,000, the rate is two-thirds (2/3) of the above rate as calculated for total receipts of \$9,000,000 or more.

"Receipts" for determining the applicable tax rate includes interest, dividends, royalties, capital gain net income, rents and all other income and includes the income of any Q Subs. Additionally, if the S corporation is engaged in a unitary business with one or more other S Corporations or pass-through entities (or C Corporations if the Commissioner finds such corporations were established for the purpose of avoiding the threshold) the total receipts of such entities must be aggregated (eliminating intercompany transactions). For the purposes of determining the rate

applicable to Category Two Income, receipts for taxable years of less than 12 months are annualized. The first part of Form 355S, Schedule S is constructed to assist taxpayers in calculating receipts for this purpose.

The S Corporation regulation was amended in 2013 to address statutory changes and other relevant developments in corporate taxation over the previous two decades ([830 CMR 62.17A.2](#)). See 830 CMR 62.17A.2 (8)(b) for additional detail on the calculation of an S Corporation's income measure.

**An S Corporation is subject to the combined reporting provisions of M.G.L. c. 63, s. 32B (i.e., to the extent the corporation is subject to the entity-level corporate excise – see 830 CMR 63.32B.2(7) Example 6).**

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### **9.1.5 Utility Corporations ([M.G.L. c. 63 § 52A](#))**

#### ***Utility Corporations (Prior to January 1, 2014)***

Prior to January 1, 2014, utility corporations were taxed at a rate of 6.5% of net income. The provisions for determining and apportioning the taxable income were similar to those applicable to business corporations. Procedures applicable to audits of the income measure for a business corporation are generally applicable to Utility Corporations filing for taxable years beginning prior to January 1, 2014. However, there are some specific statutory differences. For example, apportionment for such utility corporations was determined under M.G.L. c. 63, § 38(c) but without double weighting for the sales factor, and the definition of net income in c. 63, §52A (b) differed slightly from the definition of net income in c. 63, § 30.4. Also, utility corporations were not permitted to carry forward net operating losses.

For taxable years beginning prior to January 1, 2014, a "utility corporation" was defined under M.G.L. c. 63, s. 52A(1)(a) as every business corporation that was:

- (i) an electric company and gas company subject to chapter 164;
- (ii) a water company and aqueduct company subject to chapter 165;
- (iii) a telephone and telegraph company subject to chapter 166;
- (iv) a railroad and railway company subject to chapter 160 and every business corporation qualified under section 131A of said chapter 160 to acquire, own and operate terminal facilities for steam, electric or other types of railroad;
- (v) a street railway subject to chapter 161;
- (vi) an electric railroad subject to chapter 162;
- (vii) a trackless trolley company subject to chapter 163;
- (viii) a pipe line company engaged in the transportation or sale of natural gas within the Commonwealth; and
- (ix) every foreign corporation which is not subject to the above chapters but which is an electric, gas, water, aqueduct, telephone, telegraph, railroad, railway, street railway, electric railroad, trackless trolley or bus business within the Commonwealth and has, before January 1, 1952, been subject to taxation under sections 53 to 60 , inclusive.

#### ***Utility Corporations (On or After January 1, 2014)***

For taxable years beginning on or after January 1, 2014, utility corporations are taxed under M.G.L. c. 63, s. 39 as business corporations. Therefore, the statutory definition of a "utility corporation" no longer applies as of that date. See [Acts of 2013, Chapter 46, Sections 39 and 84](#).

Based on their activities, some corporations that were formerly utility corporations may qualify as manufacturing corporations for taxable years beginning on or after January 1, 2014.

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### **9.1.6 Financial Institutions ([M.G.L. c. 63 § 2](#)) and Financial Institution S Corporations**

The Massachusetts financial institution excise applies to banks, trust companies and federal and state savings and loan associations existing by authority of the United States, or any state or foreign country. In addition, the statutory definition in [M.G.L. c. 63 § 1](#) includes a variety of other entities including many that may not technically be “banks” but that operate in competition with financial institutions.

“Financial Institution”

(a) Any bank, banking association, trust company, federal or state savings and loan association, including all banks for cooperatives organized under the United States Farm Credit Act of 1933, existing by authority of the United States, or any state, or a foreign country;

(b) Any other institution, association, or entity which has deposits or accounts insured under the Federal Deposit Insurance Act or by the Federal Deposit Insurance Corporation, any institution, association or entity, which is a member of a Federal Home Loan bank, excluding corporations described in [Section 1 of Chapter 171](#), any other bank or thrift institution incorporated or organized under the laws of a state which is engaged in the business of receiving deposits, any corporation organized under the provisions of 12 USC 611-631 and 12 USC 3101;

(c) Any corporation subject to Chapter 167A, or registered under the Federal Bank Holding Company Act of 1956, or registered as a savings and loan holding company under federal law, but excluding a diversified savings and loan holding company unless it satisfies the definition of a financial institution elsewhere herein, including any subsidiary which participates in the filing of a consolidated return of income to the federal government;

(d) Any corporation subject to supervision by the Massachusetts Division of banks, including but not limited to collections agencies, corporations making small loans, credit card issuers, out-of-state banking associations or corporations transacting business in Massachusetts, check cashing businesses, organizations providing services to financial institutions, corporations purchasing or holding retail installment sales contracts for motor vehicles, insurance premium finance agencies, sales finance companies which purchase retail installment sales agreements or revolving credit agreements from one or more retail sellers, and mortgage lenders and brokers; or

(e) Any other corporation in substantial competition with financial institutions described in clauses (a) to (d), inclusive, which derives 50% or more of its gross income, excluding nonrecurring, extraordinary items, from loan origination, from lending activities (including discounting obligations), or from credit card activities.

Financial institutions are subject to an excise measured by net income derived from their business carried on in the commonwealth. However, they apply the rules to calculate net income set forth in c. 63, § 1 and the apportionment provisions set forth in c. 63, § 2A (instead of §§ 30 & 38 which are applicable to business corporations). The tax rate applied to the net income of financial institutions is higher than that imposed on business corporations, but on the other hand there is no non-income measure for financial institutions. As in the case of the corporate excise that applies to general business corporations, there is a statutory minimum amount due from each taxpayer that is subject to the financial institution excise. Financial institutions may also qualify

for various credits which can be used to adjust the amount of tax due. Recapture taxes on these credits generated and used, but not fully earned, may also affect the financial institution excise due.

Per [M.G.L. c. 63 § 2B](#), S Corporations that qualify as Financial Institutions do not pay tax under §§ 32D and 39. These corporations pay an entity level excise calculated as if they were a financial institution but at a reduced rate in the same manner as business corporations taxable as S Corporations under the Code.

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### **9.1.7 Security Corporations ([M.G.L. c. 63 § 38B](#))**

Massachusetts allows a corporation engaged exclusively in buying, selling, dealing, or holding “securities” on its own behalf and not as a broker to seek classification as a Security Corporation before the end of its taxable year. Once classified as a security corporation, the taxpayer is exempt from both the income and non-income measures of the corporation excise and pays instead a tax measured by its *gross* income (without apportionment) or a minimum excise of \$456. The tax rate imposed on a security corporation’s gross income is 0.33% of such gross income if the taxpayer is a bank holding company under the Internal Revenue Code, and 1.32% of gross income if the taxpayer is any other qualified security corporation. [M.G.L. c. 63, § 38B](#). Gross income of Security Corporations is gross income defined in M.G.L. c. 63, § 30 (i.e., gross income as determined for general business corporations), and therefore includes a deduction for losses from the sale or exchange of capital assets sustained during the taxable year to the extent allowable under the Internal Revenue Code.

Securities are defined by the statute as:

- (1) Equity or debt instruments and options, futures and other derivatives, traded on and acquired through a public exchange or other arm’s length secondary market.
- (2) Bonds as defined in and issued pursuant to [Chapter 23G](#).
- (3) Cash and cash equivalents (among the included are savings and checking accounts, certificates of deposit and foreign currencies).
- (4) Interests in a Real Estate Investment Trust (REIT) or a Regulated Investment Company (RIC) or a Real Estate Mortgage Investment Conduit (REMIC) so long as none of the mortgages owned by the conduit were originated by the holder thereof or by an affiliate of the holder
- (5) Mortgage-backed securities that are guaranteed by FNMA, GNMA, FHLB or FHLMC.
- (6) Collateralized mortgage obligations, so long as none of the mortgages that underlie the obligation were originated by the holder thereof or by an affiliate of the holder; and
- (7) Any other passive investment vehicles that, in the judgment of the commissioner, shall be considered to constitute securities.

An Ownership interest in a REIT that is a related member, as defined in M.G.L. c. 63, §. 311, is not considered a security for the purposes of § 38B.

To be taxed as a security corporation instead of paying tax as a business corporation or a financial institution (under c. 63, § 39 or § 2, respectively), a taxpayer must meet both form and substance requirements. If a taxpayer has not been formally classified under [Section 38B](#) it is not a security corporation and is not permitted to file as such. In order to be classified as a security corporation under [Section 38B](#), a taxpayer must affirmatively follow the procedure set forth in 830 CMR

63.38B.1(6). On a substantive basis, if a taxpayer is not engaged exclusively in the permitted transactions it is not eligible for security corporation status and can be disqualified despite having been formally classified as such. This latter requirement is an important issue to address in audits involving a taxpayer claiming security corporation status. The tax may change dramatically if the taxpayer has made even one ineligible investment or engaged in even one prohibited transaction (e.g., a loan to an affiliate). A corporation that, upon revocation of security corporation status, does not qualify as a financial institution also becomes subject to the non-income measure of the corporate excise.

Note that there is no legal requirement that a taxpayer be classified as a security corporation. If the taxpayer meets the requirements it may voluntarily seek classification for current and future years but a corporation may not seek to be classified as a security corporation retroactively.

Conversely, a taxpayer may affirmatively revoke its security corporation classification by notifying the commissioner at any time before the last day of the applicable tax period. An auditor should not convert a taxpayer from a general business corporation to a security corporation even if it meets the substantive eligibility requirements. Procedures for a corporation to apply for and/or withdraw from security corporation classification can be found at 830 CMR 63.38B.1.

Because of the low tax rates, security corporations are sometimes used by multi-entity business groups to hold funds not currently needed for business operations after stock offerings or other financing activities. By placing proceeds in a subsidiary that qualifies as a security corporation and having the security corporation invest the money, a large corporation both reduces the effective tax rate on interest and dividend earnings, and removes the assets from the parent's non-income measure of excise if it is an intangible property (net worth) corporation. In general, these relevant issues are most commonly encountered in an audit of a related business corporation or financial institution.

**Properly classified security corporations are not subject to combined reporting. A corporation that files as a security corporation but should not have done so (an audit determines it to be ineligible or to have never been classified as such) becomes subject to combined reporting by virtue of that determination.**

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### **9.1.8 Insurance and Life insurance companies (M.G.L. c. 63 §§ 20 through 29E)**

Insurance and life insurance companies as defined in various sections of M.G.L. Chapter 63 are not required to pay the corporation excise. Instead these companies are subject to a tax on premiums allocable to the commonwealth (note that there is an exception - a marine insurance company pays a tax measured by underwriting profit). Audits of M.G.L. Chapter 63 insurance companies are outside the scope of this procedure.

General insurance companies and life insurance companies are most commonly encountered during a corporate excise audit either (i) in the case of a parent corporation (which may create non-insurance subsidiaries to perform services related to the insurance business or to manage unrelated businesses purchased as investments) or (ii) in the case of a “captive” insurer formed as an affiliate to provide insurance for risks encountered in the affiliated taxpayer’s business. In the latter circumstance, auditors should note that an entity described in Chapter 63 sections 20 through 29E that does not meet the definition of a general insurance company or a life insurance company under the Internal Revenue Code is subject to combined reporting.

To be a general insurance company under the Code (or a life insurance company), a corporation

must receive more than 50% of its income from issuing insurance contracts or from reinsurance of risks underwritten by other insurance companies (see IRC § 816(a).) Insurance for tax purposes, per a 1941 Supreme Court decision (*Helvering v. Le Gierse*, 312 U.S. 531, 539), requires risk shifting and risk distributing.

*Risk shifting* requires that the possibility of economic loss be transferred from one person to another. The IRS has consistently held that an insurance contract between a parent and its subsidiary cannot shift economic risk (the parent always ultimately bears the loss) but, since 2002 the IRS has acknowledged that in brother-sister contracts a properly capitalized captive can be used to transfer risk depending on the facts and circumstances. Among the factors that might affect this determination are (a) a lack of a non-tax business purpose, (b) undercapitalization of the captive insurance company and (c) related party guarantees (see Rev. Rul. 2002-90).

*Risk Distribution* incorporates the statistical phenomenon known as the law of large numbers. Distributing risk allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as premiums and set aside for the payment of such a claim. By assuming numerous relatively small risks that are independent of each other and that occur randomly over time, an insurance company smooths out losses to match more closely its receipt of premiums (and not overwhelm its reserves). Risk distribution necessarily entails a pooling of premiums, so that a potential insured is not in significant part paying for its own risks. See *Humana Inc. v. Commissioner*, 881 F.2d 247, 257 (6th Cir. 1989).

In all circumstances where an insurance company (which is taxed on net premiums) is encountered as an affiliate of a business corporation (whose excise is based on net income), auditors should be aware that improper transfer pricing issues (including the failure of the insurance company to pay an appropriate share of common expenses) may have a significant tax effect.

**Whether or not a corporation qualifies as an insurance company under the Internal Revenue Code is typically an issue in the audit of a combined report and will be discussed in more detail there. See the combined reporting discussion in Chapter 10.**

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## 9.2 Corporate or Financial Institution Excise Audit – Overview of the Audit

The object of a Massachusetts Chapter 63 tax audit is to verify that the taxpayer has reported and paid the correct amount of tax for the years under audit review. “Correct” does not mean perfect; in all cases the auditor should be looking to focus on those items that are significant in the context of the return. This can mean not addressing an item where an error is possible (or even probable) when:

- a) the likely impact on the tax due is not significant in dollar terms, or
- b) the likely impact on the tax due is not significant in comparison to other issues on the return, or
- c) the ratio of the likely impact on the tax due to the DOR resources required to determine the correct amount of tax is below a reasonable threshold

Perfect compliance is not expected and the auditor should not attempt to enforce perfection. The amount of audit time and effort devoted to the potential audit topics should vary based on the perceived risk that the tax has been substantially understated due to an error in the taxpayer’s

calculations or their treatment of any item.

The auditor must make correcting adjustments in accordance with established audit policies and procedures to the extent any changes need to be made as a result of the audit review. Auditors will analyze information contained in the Department's corporate tax history files, as well as a variety of other internal and external sources, in order to verify the accuracy of the return data after they have examined the taxpayer's books and records. Auditors are responsible for researching and evaluating tax issues as they are encountered during the audit review in order to make legally correct audit determinations and adjustments.

An audit typically requires additional information and/or documentation beyond what is submitted with the return in order to determine the factual basis for an item included in (or omitted from) the tax return. During this process, auditors are expected to research, analyze and apply federal and state tax laws, rules and regulations (e.g. the [Internal Revenue Code](#) ("IRC") and [Massachusetts General Laws](#) ("M.G.L.")), and other public written statements to the specific facts and circumstances of each audit case. In addition, auditors must provide appropriate explanation and documentation supporting the basis for such determinations and adjustments.

A corporate excise field audit must be completed by the auditor in a professional and timely manner by adhering to applicable Department audit policies and procedures. Auditors must maintain confidentiality of information obtained or developed in the course of the audit.

Proposed audit changes must be supported through development of schedules, reconciliations, reports, and other pertinent documentation. Auditors must confer with the taxpayer and/or their legal representatives throughout the audit review to discuss and explain their audit findings and proposed adjustments. In addition, auditors are required to assist with matters which arise after the audit has been completed, including preparation for and attendance at post-audit appeal hearings and conferences.

The progress of a corporate excise audit can go in many different directions based on information previously received and the exercise of the auditor's judgment. As such, the auditor is expected to manage the audit process in a manner that will complete the audit efficiently while ensuring that the most important issues are correctly addressed. Auditors are required to identify issues needing further review and properly assess the potential value of such issues. All of these factors must be considered in planning and conducting the audit at every phase. These factors may affect decisions in prioritizing issues to be addressed and in choosing among methods to determine the correct amount for a particular item on the tax return (e.g. using a sample to estimate the correct amount of Investment Tax Credit (ITC) that should be allowed for purchases during a given year).

The general progress of a corporate audit involves:

1. Pre-Audit Analysis & Creating a Corporate Audit Plan
2. Opening Conference
3. Detailed Review of case plan issues
4. Presentation of Changes to the Taxpayer
5. Exit Conference

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### **9.2.1 Pre-Audit Analysis & Creating a Corporate Audit Plan**

The audit plan is a tool used by the auditor to manage the audit. It identifies the issues to be

addressed and the steps the auditor intends to take in order to address them. It is established at the beginning of the audit and should take into account the risk that a particular issue or item to be investigated has resulted in a substantial understatement of tax and the amount of audit resources expected to be consumed in verifying the item. It is a living plan of action. The auditor is expected to modify it as new information becomes available, adding or eliminating tasks based on the likely value of completing them. The auditor should be prepared to review the plan with either the supervisor or the taxpayer upon request.

Corporate audit cases are selected and assigned to auditors by supervisors or managers based on a variety of criteria. The first step in any assigned audit case is for the auditor to document the source of the audit and the proposed initial audit focus. If the source was an audit selection lead, documentation should include an overview of the criteria used to generate the audit leads in the audit selection request and why this particular taxpayer was selected from that list for audit review.

Once the audit case is assigned, the auditor must review records and other information already available in order to plan the audit. The following information should be reviewed for this purpose to the extent it is available:

1. General information on the company's website about its overall business, products, history, offices and customers.
2. Tax returns to be audited - this is a primary source of issues to be addressed in the audit. The standard audit workpapers package automatically checks many calculations that occur within the return (i.e. does line 1 minus line 2 actually equal line 3) and discrepancies should be resolved, but the verification of amounts entered into rather than calculated within the return is the auditor's responsibility. On each of the returns to be audited, review the net income calculations, apportionment schedules, tax credits and Net Operating Loss (NOLs) generated or used. A year-to-year comparison of the information in the return may be helpful. Look for year-to-year changes in the tangible/intangible property classification and year-to-year changes to individual apportionment factors and to the overall MA apportionment percentage.
3. Prior audit reports, logs, and work papers for the taxpayer (including any decisions from the Office of Appeals on the prior audit cycle). Issues resulting in changes from prior cycles should be checked to see that the taxpayer has made the appropriate adjustments on later returns. Carry forwards reflected in the final audit work papers should be checked against figures the taxpayer is using on returns for the current periods and adjusted accordingly.
4. If the taxpayer has not recently been audited for corporate excise tax, but has been audited for Sales & Use Tax, that audit report and log should be reviewed for information on the taxpayer's operations and any claimed qualification as a Manufacturing or Research and Development corporation.
5. Any Federal Change filings for the years to be audited or other recent years should be reviewed. These reports may show changes that directly affect the tax attributes on current year returns, or they may show areas where the taxpayer was incorrectly calculating US taxable income or credits in prior years that require examination in the current audit cycle. Note: The auditor must confirm the date of the last federal tax audit identified in previous research (an ongoing or recent federal audit may significantly affect what will be reviewed).
6. Any recent corporate excise tax abatement filings. Changes to any tax attributes carried forward into the audit period should be matched against the figures used on the returns and adjusted accordingly.

7. SEC Form 10-K (if the taxpayer is required to file one) should be reviewed, and the financial statements reported therein should be compared to information on the federal tax return to identify any issues on the financial statements that should have been reflected on the tax filings. For foreign based companies, SEC Form 20-F may be used in lieu of the 10-K.
8. DOR records should be reviewed to verify that the taxpayer has filed all required returns up to the present. This review is not limited to corporate excise tax filings. If the taxpayer has failed to file withholding or sales tax returns then the auditor should address this issue during the audit. After reviewing all of this information, the auditor will meet with their supervisor or manager to discuss the scope of the audit in terms of:
  - (a) items in the tax return to be addressed, and
  - (b) the records to be reviewed, and
  - (c) the projected time allotted to review those records.

It is not expected that auditors will give all aspects of the return equal attention. On the contrary, auditors are expected to manage and allocate more of their time to significant issues which may render meaningful audit adjustments. Issues must be weighted in accordance with the value of potential audit adjustments which are at stake.

### *Corporate Audit Risk Analysis*

Audit Risk in the context of a corporate audit is the risk that a material understatement in the calculation of the tax exists and will not be found by the auditor. Although there is no effective mathematical formula to quantify this, it should be thought of in terms of 3 elements:

1. The inherent risk or revenue opportunity represented by an item on the return encompasses the potential effect on the tax calculation if a particular item is wrong (i.e. Is the resulting change significant in comparison to other items on the return and how much in dollar terms that item actually represents?). This may frequently be estimated by a pro-forma recalculation of the excise changing the value of the item in question.

For many items on the return, the associated revenue opportunity will be low either because no conceivable change will affect the tax calculation (e.g. in the case of a manufacturing corporation that does not use the payroll factor to apportion income) or because the maximum increase in tax is comparatively insignificant (e.g. in the case of a taxpayer with a very low apportionment percentage, a change to pre-apportionment income may be immaterial). Note that in the latter scenario the revenue opportunity will increase if it is determined that the apportionment should be much higher. This may require the auditor to revalue the issue during the audit.
2. The control risk of an item is how likely it is that the taxpayer's internal controls failed to detect and correct an error that is material in the calculation of the tax. The better the taxpayer's controls, the less likely it is that a material error was made on the return even where the inherent risk/revenue opportunity was high. In evaluating the control risk, the auditor will consider the process followed to gather information that was used to prepare the return and consider both the errors that may have occurred at each step and procedures used by the taxpayer to verify accuracy.

Most taxpayers focus their internal controls on their business needs and many adapt the information from the financial systems for use in filing their tax returns when an alternative method or some adjustment may be necessary (e.g. in the case of a taxpayer claiming the

credit for research and development that uses a cost center approach for financial reporting and transfers those results to the tax return.) The auditor will also take into account the taxpayer's understanding of Massachusetts tax law with respect to an item (e.g. in the case of related member interest the taxpayer may be unaware of the addback requirement or may have a liberal view of what constitutes an addback exception.)

The auditor will also take into account prior 3<sup>rd</sup> party audit activity, including the scope of that activity. For example, a taxpayer may have their financial statements audited and the audit may have addressed the value of the inventory without addressing how much of it was in each state, or it may have verified the taxpayer's sales as they are determined under GAAP, leaving the auditor to determine if additional sales must be recognized for tax purposes. Where a taxpayer has been audited by the IRS on a specific issue for the tax year under audit by Massachusetts, the IRS audit serves as an additional control with respect to issues the IRS addressed but not for issues that the federal audit did not or would not normally consider (e.g. whether or not research activity occurred in Massachusetts with respect to the research credit). If a Massachusetts tax audit was recently completed, an issue that was thoroughly reviewed without a significant change will be considered as another positive in evaluating control risk.

In establishing and maintaining the audit plan (see below) the auditor will select issues from those with significant revenue potential considering what they know about the controls. Issues which because of perceived controls are unlikely to be the cause of significant error may be removed or devalued in determining what should be audited. These decisions should be discussed with the audit supervisor/audit manager.

3. The detection risk reflects the probability that a material error exists and has not been found either by the taxpayer (in their application of internal controls), prior auditors (in their known or presumed testing) or the auditor's own activities. This is greatest when there has been no testing and decreases as the auditor's own testing progresses. The auditor should take this into account when re-evaluating the level of risk during the audit and the same testing result may have different implications depending on the context (e.g. In a preliminary for a taxpayer with a reported sales apportionment of 40%, fifty (50) randomly selected transactions are tested. If 98% of the dollar value of the sampled transactions were properly sourced, it is less likely that a very large undetected error exists). Note that for taxpayers with low sales apportionment, "2% of the dollar value" may be significant – an increase from 3% to 5% is major even if an increase from 40% to 42% is not. Once a significant error is identified – and a change from 3% to 5% in this context is often significant, additional data may be needed to confirm it and determine the amount with appropriate precision.

As may be inferred from the discussion of detection risk, auditors are expected to re-evaluate risk periodically during the audit. Among other things, auditors should consider the following when evaluating the detection risk:

- If testing shows that large error exists, the audit should take steps to confirm this regardless of what appear to be good controls. The testing results are to be preferred to the expected results - even the best procedures fail to prevent error when they are not followed.
- If the auditor's testing shows that the range of likely results no longer includes most of the dollars originally associated with the issue, further investigation looking for a bigger adjustment on the issue may not be warranted. Audit resources not yet expended may be

better used on other issues (or even other cases).

- Where multiple changes taken together are required to increase the recovery, a determination that one of those changes is unlikely may affect whether or not the other should be pursued (e.g. if the taxpayer's low apportionment percentage is confirmed, the value of potential changes to net income will be limited by that percentage).

Note: Issues of how to apply the results of tests may result in changes to the scope of the audit and should be discussed with the supervisor/manager.

After the auditor has discussed the potential audit issues with the supervisor/manager, the supervisor will establish the scope of the audit and approve the audit plan (alternately the supervisor may discontinue the case at this point). The supervisor and the auditor should discuss how long the audit is expected to take, both in terms of calendar time and audit hours and whether or not any additional auditors may be available to help.

### ***Corporation or Financial Institution Excise Audit Plan – Checklist***

A Corporation or Financial Institution Excise audit plan will generally address one or more of the following:

- ✓ Verification of Massachusetts net income – the depth of this review may be limited to a simple comparison to the federal return and the book to tax workpapers, or may extend to a more detailed review of one or more specific items of income or deduction. The nature of the records to be reviewed will vary depending on the depth, the specific items being reviewed and the potential issues identified by the auditor.
- ✓ Verification of the "Schedule A" balance sheet – this may also be limited to a comparison to the federal return and/or a trial balance or may deal more extensively with some of the items(e.g., analysis of inter-affiliate note payables for net worth taxpayers). Note that financial institutions do not file this type of balance sheet with their returns.
- ✓ Verification of Massachusetts apportionment percentage – the extent of this review may vary from resolving simple computational issues for the line items shown on the return to how one or more of those items were created or whether the taxpayer's activities require it to use a different apportionment formula.
- ✓ Verification of credits generated in the tax year and recapture provisions, if any, have been applied – this may be limited to a review of any appropriate schedules for obvious errors or may involve detailed examination of one or more of the activities that allowed the taxpayer to claim the credit.
- ✓ Recalculation of the excise and the limitations on the use of any credits.

### Single-Issue or "Limited Scope" Audits

From time to time supervisors or managers may also assign single-issue or "limited scope" audits to review one issue or aspect of a taxpayer's return (e.g. the applicability of a specific credit or compliance with a specific provision of the law). In such cases, the limited nature of the examination and its actual scope must be disclosed to the taxpayer at the outset and later on by the auditor in the audit report. If any other issue(s) are encountered during this limited review, the auditor should briefly assess the newly-discovered issue(s) and, if it is potentially material, immediately inform their supervisor or manager at that time. This is needed so that a decision can be made whether to further expand the scope of the audit to address such issue(s), or to simply maintain the initial limited audit scope.

After the auditor and their supervisor/manager have agreed on the scope of the audit, the auditor will prepare an initial audit plan and initial information document requests (IDRs). The Corporate Excise Field Audit Initial Mandatory IDRs have been attached to the [Appendix](#) of this chapter. Additional IDRs will be prepared as necessary to address specific issues within the agreed scope of the audit. A number of standard IDR forms have been developed by Audit which should be utilized as models when addressing certain common issues that are determined to be within the scope of the audit. The preparation and issuance of these IDRs must be documented as part of the case log.

In some cases, the result of the auditor's research and subsequent discussion with their supervisor is that an audit is not warranted (i.e. if the issue triggering the audit selection was reviewed in an audit of a recent prior year and no significant change resulted, a second audit of the same issue is frequently pointless and/or an explanation for the triggering item is found in the pre-audit analysis). In such circumstances the supervisor will document the decision in the log and close the case. If the case was generated by a computer algorithm, the reason for the non-selection must be reported for use in creating future audit leads.

### Audit Log and Time Reporting

Audit log notes and time reporting provide a mechanism for auditors to record audit case activities along with how much time they spent on each case activity. When used properly they provide a running total of the time and activities expended on the case (which is a key element in the cost of completing the audit) and can serve as tool for both the auditor and the supervisor/manager. If the auditor discovers or determines that the remaining work to complete the audit is likely to require significantly more time than originally planned (e.g. if the audit was expected to be complete after 100 hours and is now likely to consume 130), the auditor must immediately discuss the circumstances with his or her supervisor or manager. In some cases it may not be in the best interest of the agency to expend the additional hours on that particular issue or this particular audit. Auditors must periodically communicate audit case progress with their supervisor or manager and are expected to be aware of how many more hours the audit should take by the time they reach the midpoint of the original estimate. In the example used above, the auditor should know well before the 100 hour mark that it will not be completed within the time in the original audit plan. In addition, when novel or complex issues arise the auditor may need to reach out for further guidance and advice after initial review and research of such issues.

Once the auditor and supervisor have discussed and determined the audit plan, the auditor will contact the taxpayer and schedule the initial field audit conference appointment. A discussion of the initial information requests ("IDRs") to be issued may assist in the audit scheduling process, and minor changes to the IDRs can be made if and when appropriate. If the taxpayer wishes to delay or defer the initial audit conference, the auditor should request and secure an executed [Form A-37](#) (waiver) from the taxpayer to ensure that there is adequate time for the audit review process due to any proposed delays to the audit start date at the behest of the taxpayer. In addition to the Form A-37, the auditor should also request that the taxpayer document in writing the reason for the delay. Once this information is received it must be attached to the case. The auditor should also document the reason for any delay in the audit case log.

After establishing an audit start date, the auditor will issue a confirmation letter for the appointment and enclose the initial IDRs. In the confirmation letter the auditor should direct the taxpayer to the DOR's online Guide to the Department of Revenue including the "[Taxpayer's Bill of Rights](#)" and "[How do Audits Work?](#)" along with any other required online references or notices (which may vary from time to time).

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### **9.2.2 Opening Conference – Corporate Tax Audit**

A corporate field audit typically begins with an opening conference at the taxpayer's business location or in some instances at the office of the taxpayer's legal representative (e.g. CPA or Accounting Firm ). Note that the auditor is required to secure the necessary documentation where applicable (i.e. MA Form M-2848 Power of Attorney (POA)) for each legal representative other than the taxpayer if it will be disclosing information, discussing or working with such representative with respect to the taxpayer's returns. See [DD 87-5](#) and [AP 614](#).

At this initial meeting, the auditor is required to go over the purpose and initial scope of the audit and the audit process, and to outline the post-audit and appeal process including appeal alternatives. The auditor should inform their audit supervisor in advance of the opening conference date so that the supervisor may attend or participate by teleconference if scheduling allows. In such situations the audit supervisor will explain post-audit and appeal process and alternatives with the taxpayer.

The auditor is expected to secure additional details about the taxpayer and its business operations so that the audit may be conducted more efficiently and any additional audit issues may be identified for review. Some of these issues are specific to Corporate Tax audits and others, more generally applicable across tax types, are discussed in Chapter 4 of the **Field Audit Procedures Manual** - [Topics to Discuss at Opening Conference](#).

Prior to the opening conference, the auditor should prepare a list of questions or topics to be addressed (other additional questions should also be raised when appropriate during the interview). Typically in the opening conference for a corporate case the auditor should address the following tax type specific issues:

1. Determine if there have been any substantial changes in the taxpayer's business or organization either in the recent past or after the periods under audit, such as a change in control, purchase or sale of a division, entry into a new market or a restructuring or reorganization of existing operations.
2. Determine where the taxpayer has facilities and what activities are performed at each location. It may be especially important in many cases to determine the location of manufacturing or R&D activities. The location and nature of any sales offices may greatly affect the sourcing of sales of tangible property and, in an audit of a financial institution, the location(s) where the taxpayer processes and/or services loans may be important in determining the property factor.
3. Determine if the taxpayer has any agreements with Massachusetts municipalities for full or partial exemption from local property taxes.
4. Determine if the taxpayer has any employees based in their homes or at any location other than an office of the taxpayer (including offices belonging to customers or taxpayer

affiliates). If so, find out where these other locations are, what these employees do and for whom they work.

5. Determine who and where the taxpayer's customers are and what services it provides to those customers (even if its primary business is selling tangible property).
6. Identify the taxpayer's business model and revenue streams and note any differences when revenue is recognized for book purposes and for the tax return.
7. Determine how revenue streams are segregated and how each is treated for apportionment purposes. For sales treated as tangible receipts for apportionment, how does the taxpayer determine the destination state? For sales of services, how does the taxpayer identify separate items of income and how do they identify the location of sales of services when allocating those separate income items.
8. If the taxpayer receives royalties, determine what property is being licensed, how the amount due is calculated and how the royalties are allocated for apportionment.
9. For taxpayers in a combined group, review the role of each corporation in the unitary business and the location of its business activities. Determine how the taxpayer identifies and eliminates intercompany transactions in the federal consolidated income tax return.
10. Ask about the existence of any closely affiliated business units and/or individuals and determine the nature and purpose of any transactions between the taxpayer and those affiliates.
11. Determine how prices and other terms are established for transactions between related parties (including transactions between members of a federal consolidated group and transactions between the taxpayer and other related parties).
12. Identify and evaluate taxpayer's internal controls, especially as they relate to proper allocation of income and expenses between business units and the management of fixed assets.
13. What are operational managers responsible for and what transactions affect the tax return but are transparent to those managers? Is there a separate manager with P&L responsibility for each legal entity?
14. Confirm any other information the auditor may have acquired from the pre-audit review on which the auditor expects to rely in completing the audit.

In preparing this list of issues to address in the opening conference (and throughout the audit), the auditor should bear in mind the degree of audit risk associated with each possible issue. In this context, the audit risk associated with an item on a return is the risk that the tax shown on the return is materially different than the tax properly due.

Auditors should probe to understand the controls the taxpayer may have in place – what is already being done to ensure that the figures being reported are accurate. The auditor may sometimes choose to initially rely on a taxpayer's internal controls until evidence surfaces that they are not effective. To the extent a 3<sup>rd</sup> party may have reviewed all or part of a taxpayer's return the auditor may choose to consider that person's work in planning his/her own review. This may involve an IDR for workpapers or correspondence between the taxpayer and that 3<sup>rd</sup> party so that the auditor can verify the scope of that prior review. As always, areas that will have little or no impact on tax liability for this particular taxpayer should not be a primary focus of the audit.

As soon as practicable after completion of the opening conference, the auditor should schedule a tour of the taxpayer's facility. If the auditor has determined in advance that a facility tour is

warranted (e.g. the taxpayer is a manufacturer or is claiming the research credit), the tour can be scheduled on the date of the opening conference if the taxpayer contact is available to provide one. The facility tour can frequently identify other issues to be addressed during the audit and helps the auditor get a better understanding of the taxpayer's business operations. The auditor may dispense with the tour if it is not expected to be of value. If, as the audit progresses, the auditor later determines that a tour would be relevant it should be requested in writing. Both the opening conference and the tour (or the decision to forego the tour) must be documented.

Note: The Department of Revenue is obligated to complete audits in a timely manner. Under M.G.L. c. 62C § 32(f) the rate of interest on a deficiency assessment is reduced if the NIA is not issued within 18 months after the date of the opening conference (or the audit notification in the case of a Desk Audit). The interest rate reduction (and a further reduction after 36 months) applies provided the Department determines that the taxpayer complied with all requests for information or documentation with substantial promptness and completeness and where the taxpayer is not otherwise responsible for the extended duration of the audit.

The determination of whether or not the delay in completing the audit was for a reason that would not result in an interest rate reduction (and the extent to which it should be attributed to such reasons) is a question of fact. If the auditor at any time believes this time limit will be exceeded and that the responsibility for some or all of the delay rests with the taxpayer, the auditor may (after discussing the issue with the supervisor/manager who must agree that the delay is attributable to the taxpayer) suggest the taxpayer sign form A-32 to remove the issue of the interest rate reduction from the audit. Examples of when this might be appropriate would include a suspension of an audit already in progress at the request of the taxpayer or a request by the taxpayer to go to mediation. Consequently, any request for a delay, or for additional time to respond to an IDR by a taxpayer, should be both noted in the case log and confirmed in writing by the taxpayer (and such written confirmation should be attached to the audit case).

See [FAPM Chapter 4](#) for further details regarding Form A-32.

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### **9.2.3 Detailed Review of Case Plan Issues – Corporate or Financial Institution Audits**

After the opening conference the auditor is expected to complete the case using the audit plan created for that specific audit as a tool. Specific Information is requested and reviewed to address issues identified in the plan. As the case develops the auditor may need to follow-up with more detailed requests on some issues. Other issues may be resolved, either with proposed changes or with acceptance of the taxpayer's return position.

#### ***Information Document Requests (IDRs)***

The auditor gathers the factual information needed to address audit issues in a timely and efficient manner by issuing detailed Information Document Requests (IDRs). IDRs, representing formal written requests for the taxpayer to produce specific documents or other (specific) evidence or information to verify the tax treatment of any item on the return, establish a record of correspondence and communication between auditor and taxpayer.

- 1) Each IDR should be customized to the taxpayer and, where appropriate, to the industry. All IDRs should be written in clear, concise language and should be numbered for ease of reference in future discussions.
- 2) IDR's issued after the opening conference should be specific to a single issue and, where multiple items are requested, numbering and lettering should be used to clarify the items

in subsequent discussions.

- 3) In an effort to get the required information in the most efficient manner, the auditor may discuss with the taxpayer the particular issues to be addressed and the documentation to be requested during the drafting process. If, during such discussions, the auditor makes a verbal request for information, a follow-up request should be made in writing to document the specific items to be produced. This written follow-up should be made as soon as possible to minimize the possibility of the taxpayer expending resources producing the wrong records.
- 4) The auditor may choose to, but is not required to, share a draft of the IDR with the taxpayer (taking care to ensure that it is clearly identifiable as a “draft”). The knowledge of the taxpayer’s personnel may assist the auditor in determining what records are most likely to provide the desired information, but it is the auditor’s responsibility to determine what records are needed to complete the audit. The auditor, not the taxpayer, determines what will be requested in the IDR.
- 5) An IDR must specify a response date. What constitutes a reasonable timeframe for a response may be discussed with the taxpayer before the IDR is issued, but where agreement cannot be reached, the auditor will set a reasonable response date.
- 6) Auditors are expected to review IDR responses as soon as possible after they are received to determine whether or not the response is complete with respect to the questions asked. The auditor should notify the taxpayer if the review cannot be completed within 30 days. Auditors may wish to discuss the response with the taxpayer as they are reviewing it to clarify any part of the response. To the extent the response received does not provide the required information, a written follow-up communication is required.
- 7) If the information and/or documents requested are not provided by the due date or the documentation that is provided is insufficient, the auditor and supervisor should discuss alternatives, including an administrative summons. The failure to issue a summons does not imply that the information/documentation is no longer required; other factors such as a short statute of limitations may operate to discourage the auditor from pursuing the summons.
- 8) Additional guidance on the summons process is available in the [Appendix](#).
- 9) More commonly, the auditor’s review of the information provided in response to the first round of IDRs will indicate some specific additional documentation is needed. Requests for additional information should be made through additional IDRs when necessary. In addition to copies of the IDRs as actually issued, the auditor is required to maintain a log of all requests for information recording the date issued, the date the response was received and notes about the sufficiency of the response or follow-up action. A sample IDR log can be found in the [Appendix](#).

As noted above, the auditor should follow-up on “past due” IDRs as part of the audit. At the conclusion of the audit, a final list of open IDR’s should be provided to the taxpayer together with a deadline so that both the taxpayer and the auditor can ensure that all issued IDRs have been addressed and the taxpayer has a final opportunity to provide whatever information it has to respond to the audit information requests.

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#### **9.2.4 Presentation of Changes - Corporate or Financial Institution Audit**

The auditor's review will identify potential changes to the treatment of items on the taxpayer's return which should be organized and presented to the taxpayer as they are developed and prior to the presentation of summary workpapers showing the net change to tax. Proposed changes to items in the return should be addressed to the taxpayer on an issue by issue basis with reference to the law and facts. Each notice of a proposed change to an item on the return should request response(s) by a certain date, and the taxpayer should be encouraged to contact the auditor with any questions or concerns.

The taxpayer should be strongly encouraged to present additional information and/or raise new issues prior to the audit exit conference. An example of a notice of a proposed change can be found in the [Appendix](#).

Changes made to the treatment of items on the return typically flow from a series of mathematical calculations and result in an increase or decrease in excise tax. Although standardized workpapers may automatically project these changes through the entire return as they are entered, the auditor's focus (and the taxpayer's) should be on determining if the proposed changes to individual items should be made or if, upon review of the taxpayer's response, the proposed change should be modified or even withdrawn. Changes to multiple items will each affect the tax calculation. The change in actual tax, if any, is not known until each of the open issues are resolved. Thus, if the auditor determines that the taxpayer's pre-apportionment net income should be increased, that change will be vetted through this process. Interdependent changes should be presented together, such as:

- adding factors to an apportionment denominator, some of which are also being added to the numerator,
- Including income and applicable factors from a disregarded entity, or
- Reattributing factors from one entity to another in the audit of a combined report

The proposed net change to tax should normally be presented only after the auditor has made decisions on all open issues. If circumstances (such as the impending expiration of the statute of limitations for assessment) dictate that the net change to tax be presented without allowing the taxpayer to first review some of the item changes, the notice of those proposed changes (showing the factual and legal references) should be included with the workpapers showing the change to excise.

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#### **9.2.5 Exit Conference – Corporate or Financial Institution Audit**

An exit conference for a corporate tax audit should typically be scheduled after the taxpayer has responded to the proposed changes and been provided with final audit calculations.

At the exit conference, the auditor and the audit supervisor/manager should be prepared to discuss positions taken during the audit to assist the taxpayer in determining whether or not an appeal should be filed. If there are areas of substantial disagreement and the case otherwise qualifies (e.g. the taxpayer has been cooperative during the audit and provided all required information), Audit may propose mediation of the disputed issues; if mediation is an option, the auditor may wish to prepare pro-forma workpapers without the disputed changes to ensure there is no disagreement as to the amount in dispute.

Where there are agreed changes that are likely to have significant effect in years already filed but subsequent to the audit period, the auditor may discuss whether the taxpayer will file amended returns consistent with the audit findings. If a follow-up audit is indicated, either because the taxpayer is unwilling to amend the returns or because there are significant changes that are not agreed, the department's intentions should be discussed with the taxpayer at this time.

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### 9.3 Verification of MA Taxable Net Income

The Financial Institution Excise tax and the largest share of the Massachusetts Corporate Excise Tax are measured by net income. The excise tax is not a direct tax on net income, but is instead an excise or privilege tax measured by net income. This classification or distinction avoids issues that might otherwise arise due to inclusion of interest on U.S. obligations in the excise base.

The starting point for the determination of taxable net income is gross income. (see [M.G.L. c. 63, § 30.3](#)) Gross income for Massachusetts corporate excise tax purposes is defined as gross income under the federal internal revenue code for the taxable year, plus interest on bonds, notes, and other indebtedness of state or local governments (including Massachusetts). Other specific modifications are found in c. 63, for example, gross income for c. 63 is determined without regard to IRC section 108(i), which allows a taxpayer to defer recognition of certain cancellation of debt income for federal income tax purposes. Section 30.3 also includes a limited exclusion for receipts derived from sales, leases or other transfers of property or materials manufactured in Massachusetts subject to certain energy conservation or alternative energy patents.

Massachusetts Taxable Net income ([M.G.L. c. 63, § 30.4](#)) is gross income less the deductions (but not credits) allowable under the Internal Revenue Code as amended and in effect for the taxable year *except that* deductions related in whole or in part to one or more classes of income that are excluded from Massachusetts taxable net income as determined under M.G.L. c. 63 § 38(a) are not allowed with a clarification that the inclusion of 5% of certain dividends eligible for deduction in taxable net income under that section is in lieu of disallowing deductions related to those dividends;

However, deductions with respect to the following items are not allowed:

- (i) The Federal deduction for dividends received (however, Massachusetts has its own version of this deduction at M.G.L. c. 63 § 38(a) which is discussed below);
- (ii) Losses sustained in other taxable years – this applies to both operating losses and capital losses (however, Massachusetts has its own version of a carryover deduction for net operating losses at M.G.L. c. 63 § 30.5 which is discussed below);
- (iii) Taxes on or measured by income, franchise taxes measured by net income, franchise taxes for the privilege of doing business and capital stock taxes imposed by any state;
- (iv) The special depreciation allowance provided under IRC § 168(k);
- (v) Interest expense paid, accrued or asserted in connection with a dividend of a note or similar obligation stating the requirement that such interest is to be paid by the corporation that dividends such obligation to its shareholders (except as allowed under M.G.L. c. 63 § 31J); or
- (vi) The deduction allowed by IRC § 199 related to production activities.
- (vii) The increased deduction allowed for certain high yield discount obligations under Section 163(e)(5) of the Code under Section 1232 of PL 111-5 (the American Recovery and Reinvestment

Act of 2009)

The auditor must verify that these deductions have been addressed by the taxpayer and make adjustments accordingly.

The auditor should also review the federal R&D credit to verify whether the IRC § 280C reduced credit was claimed. The text of § 30.4 includes a provision specifically allowing taxpayers required by IRC § 280C to reduce their federal deduction for wages paid by the amount of any federal tax credit under IRC § 51 to take the unreduced deduction in calculating Net Income for Massachusetts, therefore requiring that MA taxable net income be increased by the amount of the MA tentative credit.

Other provisions in c. 63, § 38M and elsewhere also specifically allow additional deductions in specific cases, but without such authority, amounts disallowed federally are disallowed in Massachusetts calculations as well.

The definitions of “Gross Income” and “Net Income” for Financial Institutions are essentially the same as those used by Business Corporations and are found at [M.G.L. c. 63 § 1](#). The following differences should be noted:

- Financial Institutions do not get the additional deduction for wages expense allowed to business corporations under c. 63 §30.4 (reversing the cutback under IRC § 280C.)
- Financial Institutions do not get the equivalent to the c. 63 §30.3 exclusion for income from energy patents that is allowed to business corporations.
- Financial Institutions are not subject to the equivalent of the c. 63 §30.4 (v) restriction on the deduction of interest paid on dividend notes. They are subject to the general addback provisions of c. 63 §§ 31I – 31K (see below).
- The provisions of IRC §291 (limiting corporate tax preference items generally and including a special restriction on financial institution preference items at §291(d)) do not apply to Financial Institutions and the provisions of IRC § 172(a)(2) and §265 relating to disallowance of expenses attributable to tax exempt bonds apply only to the extent the income is excluded from Massachusetts Net Income.

Utility Corporations (during the taxable years beginning prior to January 1, 2014 when they were taxable under [M.G.L. c. 63 § 52A](#)) use similarly modified definitions for “Gross Income” and “Net Income.” A Massachusetts S Corporation that is a Financial Institution will use the § 1 definitions of Gross and Net Income. Other Massachusetts S Corporations use the § 30 definitions applicable to Business Corporations as detailed above.

Except as otherwise expressly provided, federal gross income and allowable deductions are determined with reference to the activities of the corporation calculating those items without regard to the federal consolidation regulations. Thus a REIT or a RIC will be allowed a deduction for dividends paid if they qualify for one separately, transactions between members of a US consolidated return are not deferred (except as provided in 830 CMR 63.32B.2 within a combined report), and a non-US corporation will determine its gross income under Code §§ 881(a) and 882(b) instead of including all income worldwide as a US corporation would.

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### **9.3.1 Review of Financial Statements provided to shareholders**

Unless circumstances require another approach, the first step in reviewing taxable net income for

Massachusetts should be a review of the trial balance and the income statements prepared by the corporation for its owners and the controls already in place there. Corporations generally report financial results (profit or loss) to their shareholders and maintain accounting systems to track income and expenses. The records in these accounting systems provide internal reports to managers of the business for use in making operational decisions. Federal Income tax reporting is typically done using the same records with adjustments as required by the IRC, and those specific adjustments (“Book to Tax”) are reportable by the taxpayer with their federal return and can be reviewed individually by the auditor. The federal amounts are further adjusted when calculating the Massachusetts excise as required by Massachusetts law. These specific adjustments (“Federal to Massachusetts”) are reportable with the return and can be reviewed. An error or a misclassification in the trial balance or in the calculation of book income or expense will typically flow through to the Massachusetts return.

**Social Service Agency**  
Comparative Trial Balance - Comparative Trial Balance  
From 1/1/2010 Through 12/31/2010

Account Code	Account Title	Begin Report Period Balance	Current Balance	Net PTD \$ Change	Net PTD % Change
40001	State Grants Revenue	(470,899.55)	(974,744.28)	(503,844.73)	107.00%
40101	Federal Grants Revenue	(305,064.80)	(674,084.70)	(369,019.90)	120.96%
44001	Investment and Interest Revenue	(34,855.55)	(84,969.74)	(50,114.19)	143.78%
45001	Service Fees	(233,886.15)	(468,398.28)	(234,512.13)	100.27%
46001	Education Program Revenue	(696,959.75)	(1,503,500.90)	(806,541.15)	115.72%
46101	Community Training Revenue	(759,090.24)	(1,603,256.11)	(844,165.87)	111.21%
46201	Health Program Revenue	(491,957.10)	(1,064,354.37)	(572,397.27)	116.35%
46401	Finance Charge Revenue	0.00	(450.00)	(450.00)	(100.00)%
46501	Sale of Educational Material	0.00	(3,762.50)	(3,762.50)	(100.00)%
49999	Other Revenues	0.00	(194.97)	(194.97)	(100.00)%
50001	Salaries	626,958.40	626,958.40	0.00	0.00%
50002	Overtime Expense	250.00	250.00	0.00	0.00%
50003	Bonus Expense	500.00	500.00	0.00	0.00%
51001	Payroll Taxes	3,500.00	3,500.00	0.00	0.00%
51020	Social Security Taxes	32,162.80	32,162.80	0.00	0.00%
51030	Medicare Taxes	8,873.80	8,873.80	0.00	0.00%
51040	Federal Unemployment Taxes	210.00	210.00	0.00	0.00%
51060	State Unemployment Taxes	870.00	870.00	0.00	0.00%
51090	Worker's Comp Expenses	1,885.96	1,885.96	0.00	0.00%
51101	Health Insurance	31,147.00	31,147.00	0.00	0.00%
51105	Life Insurance Exp	47.46	47.46	0.00	0.00%
51150	Retirement Matching Exp	11,915.58	11,915.58	0.00	0.00%
51201	Other Employee Benefits	23.48	46.96	23.48	100.00%
52001	Contract Services	7,912.65	11,244.09	3,331.44	42.10%
52101	Consulting Expenses	213,648.76	429,018.45	215,369.69	100.81%
52201	Legal and Professional Fees	261,210.90	515,168.31	253,957.41	97.22%
53001	Public Relations Expense	62,229.77	130,213.91	67,984.14	109.25%
54001	Dues & Fees	7,622.37	21,613.02	13,990.65	183.55%
54101	Subscriptions	787.98	4,452.33	3,664.35	465.03%
55001	Building Rent	69,703.51	140,104.05	70,400.54	101.00%
56001	Utilities and Maintenance Expenses	45,637.38	84,193.72	38,556.34	84.48%

The income verification typically starts with a trial balance report for the year showing the ending balances for the various income, expense, asset, liability and equity accounts from the taxpayer's accounting system. The trial balance provides detail that is not available from higher level reports (including the tax returns) which are usually created by “mapping” dozens of accounts, sometimes across multiple business units, into a single item. The risk is that the taxpayer has failed to identify an item of special significance in the calculation of the Massachusetts excise, something that will not be apparent from review of a higher level report. In reviewing the trial balance (preferably in concert with a chart of accounts or procedures describing the different

accounts), auditors should not only flag items of interest that are present but also absent items that should be present (e.g. non-deductible lobbying expenses for a business that should have them). Depending on the size of the enterprise, a breakdown of the entire trial balance by business unit or even legal entity may not be practical. The auditor may choose to request that type of breakdown only for selected accounts after reviewing the overall trial balance.

The financial statements are created either from the trial balance itself or from the same records that produce it. Typically there are working papers showing adjustments made in this process and any mapping of the accounts in the trial balance to financial statement or (ultimately) to the federal tax return. Both may be useful in determining the extent to which the auditor may rely on the work already done by the taxpayer or their agent.

When reviewing the financial statements provided to shareholders, auditors will generally consider both the numbers reported and any notes or other materials that may have been prepared at the same time. Most large corporations will have their financial statements either reviewed or audited by a 3<sup>rd</sup> party in an effort to provide some assurance to stockholders, lenders, and others that the statements were prepared according to certain standards. As part of their work, the 3<sup>rd</sup> party will provide an overview of the business and the nature of their engagement, together with disclosures that may or may not have relevance to the tax audit. Among the issues that may be highlighted by a review of these financial statements (this is not an exhaustive list.)

1. The presence of affiliated entities and transactions with them (these may suggest combined reporting is appropriate or that transfer pricing should be reviewed.)
2. Significant changes in the business (acquisitions or divestitures) which may have tax consequences.
3. Notice that the Internal Revenue Service (or another taxing authority) has proposed a significant change to a prior year's return that may require adjustment to a prior Massachusetts return or highlight an issue that might need to be added to the current audit.
4. Items that may require special treatment on a tax return such as capital losses which may be limited for tax purposes or restatements of book income for prior years.

Auditors should be alert to circumstances where the financial statements provided are for a business enterprise that does not exactly correspond to the corporation (or combined group) being audited. For example, the activities of foreign subsidiaries will typically be consolidated in the results provided to shareholders. In such circumstances, transactions between the taxpayer and its affiliates that may require audit review will not be highlighted in the financial statements or the notes that accompany them.

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### **9.3.2 Book to Tax (Federal) Adjustments**

The Federal Internal Revenue Code defines both gross income and allowable deductions. Under the Code, gross income is any income from any source unless some specific section of the Code excludes it. The Code allows deductions for ordinary and necessary business expenses, again with modifications made by Congress. Although income and expenses are generally taken into account for tax purposes in the same accounting period in which they are reflected for book purposes, under the Code and Treasury Regulations taxpayers may be required to include income

or delay deductions in their calculation of taxable net income for the year regardless of the treatment for book purposes.

A taxpayer's federal income tax return includes either a Schedule M-1 or a Schedule M-3 listing the adjustments made to the income and expenses reported to the shareholders in converting book income to taxable net income under the Code. Form M-3 is far more detailed and is required to be used by the largest corporations (currently those with assets of \$50 Million or more - this was \$10 Million or more prior to the 2014 tax year).

The first step in verifying the book to tax adjustments is to verify the starting point: book profit or loss. If the taxpayer is required to file financial statements with the SEC and those were not the financial statements provided to the auditor, an explanation is necessary (statements filed with the SEC would still be available for review through the SEC's website.) Form M-1, line 1, *Net Income (loss) per books* or Form M-3, Part 1, Line 4a, *Worldwide consolidated net income (loss) from income statement source* should be matched to the book income figures from the financial statements provided and reviewed (above) with discrepancies explained.

As stated above, Schedule M-3 has more detail than Schedule M-1. The M-3 begins with a reconciliation of the book income for the entire enterprise reported to the shareholders to the book income of the specific taxpayer (or group of corporations) filing the federal return. Typically profits and losses of non-US subsidiaries are removed, along with those of earnings of US entities not consolidated for federal income tax purposes (i.e. the taxpayer's share of earnings from a 60% owned US subsidiary will typically be included in the results provided to shareholders but not in the owner's federal income tax return.) Auditors should be aware that federally excluded entities may be subject to Massachusetts Combined Reporting or (as noted above) there may be transfer pricing issues with wholly owned foreign subsidiaries. Auditors should also consider investigating the inclusion of a substantial loss in "book income" for the tax return that was not reported to the shareholders. The reason for not reporting the loss to the shareholders could indicate that it should not be deductible on a Massachusetts tax return either.

Note that Schedule M-3, Part 1, Line 11, Net Income (loss) per income statement of includible corporations, generally corresponds to Form M-1, line 1, *Net income (loss) per books*. Beginning in 2014, corporations with assets of \$10 Million or more but less than \$50 Million will file schedule M-3 part 1 but will file schedule M-1 and not schedule M-3 to report the specific book to tax differences.

The M-1 (or the M-3) is a list of the differences between book income and federal taxable net income, with detail required as an attachment for items lumped into an "other items" category. For each adjustment shown on schedule M-1 or M-3, the taxpayer should be able to identify the Code section requiring the change and provide detail on the calculations (book to tax workpapers) if requested. Auditors may refer to the Code itself or to a separate (partial) list of federal income tax issues likely to be encountered. See [Selected Issues in Reviewing the Federal Return](#) below.

Where schedule M-3 has been filed with a consolidated federal return, the taxpayer is required to complete both Part II and Part III with consolidation schedules (separate figures for each member of the group). Auditors should consider whether favorable changes shown for an individual member of the federal consolidated return and flowing up to the federal consolidated figure for any line item should be reversed in the calculation of Massachusetts gross income or deductions. Auditors should use sound business judgement in determining which adjustments to review.

Note that temporary differences – which should be offset by corresponding differences in previous or future years - may sometimes have lower priority as long as the taxpayer is consistent in their treatment of any item. However, permanent M-3 differences will require further scrutiny due to their nature.

The end result of the taxpayer's federal schedule M-1 (as shown on Line 10) or federal schedule M-3 (Line 30, column (d)) calculations must equal the amount on the taxpayer's Form 1120, page 1, line 28 as filed with the schedule M provided to the auditor. If it does not, the discrepancy must be explained.

In addition to reviewing book to tax changes that are reported by the taxpayer, be alert to what is not shown but likely in light of the taxpayer's business. Auditors should familiarize themselves with the income items listed on Schedule M-3 Part II and the expense/deduction items on Schedule M-3, part III which list typical Book to Tax changes.

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### **9.3.3 Selected Issues in Reviewing the Federal Return**

The Internal Revenue Code defines both gross income and deductions which are applicable in determining the taxable net income for a Massachusetts chapter 63 return. It is not practical or within the scope of this procedure to provide detailed or even limited guidance on all of **Subtitle A – Income Taxes**.

#### **Gross Income**

IRC § 61(a) defines "Gross Income" broadly ...

Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including but not limited to ...

In verifying gross income auditors must first be aware that most large business enterprises want to report income to shareholders. Audit issues most typically arise from income shifting, where a related group of entities attempts to assign income to a member that is not taxed or is taxed at a low rate, perhaps by assigning rights to property that produces income to that person. In this scenario, there is no change in what the shareholders see (the income has not disappeared from their pockets), but there may be significant consequences to the taxing jurisdiction from which the income has been shifted.

M.G.L. c. 63 § 39A provides that the net income of a business corporation that is a parent or subsidiary of another corporation, or is closely affiliated by stock ownership with another corporation, is determined by eliminating payments to affiliates in excess of fair value and by including fair compensation for goods and services provided. IRC §482 similarly provides that income and deductions may be allocated between businesses (whether or not incorporated) that are owned or controlled by the same interests. Note that payments between or among affiliated corporations under common ownership represents an intercompany flow of value and may be an indication that they are engaged in a unitary business. Therefore, the auditor should investigate whether the corporations are required to file a Combined Report pursuant to M.G.L. c. 63 § 32B (see Chapter 10 Combined Reporting).

The exclusions section of Schedule M-3, part 1, is designed to highlight possible income shifting, as are the requirements for taxpayer disclosure of transfers of property to foreign affiliates. A thorough review of the federal return is frequently the first step in identifying those issues. If an auditor uncovers a scenario of this type, a review of IRC § 482 (Allocation of Income and

Deductions) and related regulations is recommended.

Another scenario with possible tax consequence involves “recognition” triggers where the Code requires income to be recognized for tax purposes. If a taxpayer is able to claim a deduction while avoiding the reporting of the income to which it relates, they have at least deferred their tax. If they can do it again next year, the taxpayer will always be a year ahead in reducing his/her income. Amounts the taxpayer has received but not yet recognized for book purposes are typically shown as liabilities on the balance sheet (to offset the cash received). These may be shown as unearned or deferred income. Determine if it is truly unearned as of the end of the year or if it should be reported in current year earnings. Prepaid amounts are generally taxable when the taxpayer receives the money if they have unlimited control on the use or disposition of the funds under the “claim of right” theory. The timing of reporting income and taking deductions is governed by Treasury Regulation section 1.446-1 (c) (1) (ii).

Auditors should be alert to the discharge of indebtedness which is generally income except as provided in IRC § 108, and exchanges of property which are typically considered a sale (e.g. an exchange of one thing for another is treated as a sale for the fair market value of what is received, requiring the taxpayer to recognize as income the gain with respect to any appreciated value, unless some provision of the Code negates this). A taxpayer which takes advantage of a drop in interest rates to repurchase its own debt at a discount may have to recognize income from that transaction. See Treasury Regulation section 1.61-12(c)(2).

Corporate reorganizations also have strict rules for taxpayers claiming non-recognition under the Code. A taxpayer may not have met the statutory requirements, so this should typically be considered for further review. A review of the Code section under which non-recognition is claimed is frequently the first step in any investigation.

Where a federal audit has been conducted, the auditor needs to address all of the potential MA changes, including taxable income. For example, a federal change in gross receipts may also effect the taxpayer’s MA apportionment under Schedule F.

### **Deductions**

IRC §162(a) broadly allows a deduction for all “ordinary and necessary” business expenses, and the Code then proceeds to narrow this. Auditors should be aware of the narrowing. A few issues to be aware of:

IRC § 162(c): All taxpayers are barred from deducting illegal payments made in the course of business. If a taxpayer has acknowledged illegal activity involving bribes, kickbacks, etc. (most likely this will be obvious if the company is a publicly traded corporation), verify that they have made any schedule M adjustment to remove unallowable expenses from the tax return.

IRC § 162(e): Taxpayers are barred from deducting expenses incurred to influence legislation, to participate in a political campaign, to attempt to influence the public with respect to elections, or to influence official actions of certain officials. Exceptions are allowed to taxpayers in the business of influencing legislation (e.g. professional lobbyists may deduct their expenses of doing business) and for certain local legislative matters. If the nature of the corporation's business is such that it is heavily dependent on government action (e.g. Medicaid vendors), they may well have in-house expenses, consulting expenses or both. Any adjustment should have been made via Schedule M.

IRC § 162(f): Taxpayers are barred from deducting fines and penalties. These may be imposed with respect to taxes or any part of the taxpayer's business (significant fines are often disclosed in the financial statements as are settlements with regulatory agencies that are most likely to include fines). Any adjustment made by the taxpayer should show up on Schedule M.

IRC § 162(m): Publicly held corporations are prohibited from deducting more than \$1,000,000 in compensation expenses to certain employees excluding "performance-based" compensation. Any adjustment made by the taxpayer should appear on Schedule M. Employers may not shift compensation from one year into another to avoid application of this rule. The IRS has issued an Audit Techniques Guide on the subject that the auditor may wish to review this if the issue appears during audit.

IRC § 163(j): Certain thinly capitalized corporations (debt to equity ratio > 1.5 to 1) are not allowed to deduct some or all of the interest paid to related persons not subject to tax under Subtitle A of Title 26 (U.S. Income Taxes). A limit is imposed of 50% of the corporation's adjusted taxable income as computed under this subsection. Interest not allowed as a deduction may be carried forward to future years. This applies most frequently to corporations borrowing money from foreign owners or affiliates, and the auditor may disallow deductions that meet the technical requirements for exception to the add-back provision based on taxes paid by the recipient to foreign countries. Any adjustment made by the taxpayer should appear on Schedule M and may be favorable to the taxpayer in some years (due to the provision for carrying forward interest disallowed in one year to another). Note: IRC § 163(j) requires this to be calculated on an aggregated basis whether or not the affiliated corporations file a federal consolidated return.

IRC § 163(l): Corporations are denied a deduction for interest paid in equity of the corporation issuing the debt instrument of a related party. Any expense of this nature should be eliminated via Schedule M.

IRC § 170(b): Corporations are not allowed to deduct charitable contributions in excess of 10% of their taxable net income (with some modifications) in any given year. Any amount not allowed as a deduction may be carried forward to future years. Any adjustment made by the taxpayer should appear on schedule M and may be favorable to the taxpayer in some years (due to the provision for carrying contributions disallowed in one year to another).

IRC § 263A: Certain taxpayers engaged in production and resale activities are required to consider direct costs and the allocable portion of indirect costs as part of their inventory, deducting them not as expenses but as a cost of goods sold when that inventory is sold (and not when the expense is paid). This adjustment, if applicable, should appear in both the COGS and on Schedule M.

IRC § 264: Taxpayers are not allowed a deduction for premiums on any life insurance policy, endowment or annuity contract if the taxpayer is directly or indirectly a beneficiary under the policy or contract. This provision extends to amounts paid or accrued to purchase or carry such a contract. This issue is frequently seen in connection with "Split-Dollar" life insurance contracts where the corporation is entitled to recovery of premiums paid on the death of the insured (with the remainder going to the insured's family). Amounts paid to carry such a contract include interest expenses paid to a 3rd party by a corporation that at the same time has significant cash value in the policy. This adjustment, if made, will appear on the Schedule M.

IRC § 265(a): Taxpayers are denied a deduction for expenses allocable to producing tax exempt income. This most frequently occurs when a taxpayer who has interest expenses simultaneously owns tax exempt bonds. Any expense of this nature should be eliminated via Schedule M.

Note: Expenses disallowed by IRC Section 265(a) do not become allowable in computing Massachusetts Net Income merely because Massachusetts requires the federally tax exempt income to be added when determining the income measure of excise.

IRC § 267: Taxpayers are denied a deduction for losses in exchanges between related parties.

The same provision also requires taxpayers to defer deductions of expenses or interest paid to related persons if, due to differences in the method of accounting, the recipient is not yet required to include the payment in income. Any adjustments should be noted on Schedule M.

The following demonstrates the application of section 267 in a cross-border context:

FC, a corporation incorporated in Country X, owns 100 percent of the stock of C, a domestic corporation. C uses the accrual method of accounting in computing its income and deductions, and is a calendar year taxpayer. In Year 1, C accrues an amount owed to FC for interest. C makes an actual payment of the amount owed to FC in Year 2. Regardless of its source, the interest owed to FC is an amount to which this section applies. Pursuant to the rules of this paragraph (b), the amount owed to FC by C will not be allowable as a deduction in Year 1. Section 267 does not preclude the deduction of this amount in Year 2.

See Treas. Reg. 267(a)-3(b)(4) Example 1.

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### **9.3.4 Federal to Massachusetts Adjustments**

As noted above, Massachusetts law requires certain adjustments to either federal gross income or federally allowable deductions. This section will briefly discuss issues to be addressed. Except as otherwise noted, the adjustments apply equally under M.G.L. c. 63 §§ 1 or 30 or 52A (and thus equally to Financial Institutions, Business Corporations and pre-2014 Utility Corporations).

Again the first step in this process is to verify that the starting point (reported federal net income) is correct. In most cases, the figure reported on the Massachusetts return should match the US Form 1120, line 28 (some federal returns have different line numbers). In the case of a Massachusetts combined report filed under an affiliated group election where there is no difference between the members included in the Massachusetts and federal returns, it may be possible to match just the consolidated amounts. In other cases, the amounts reported to Massachusetts for the individual members on schedule U-M may be matched to the separate amounts reported on the consolidation schedules filed with the federal return. Note that where there is a discrepancy in the membership of the federal consolidated group and the membership of the Massachusetts combined group filing a combined report, the issue must be resolved as part of the audit.

#### **Federal Wage Credit Adjustment (*does not apply to Financial Institutions or pre-2014 Utility Corporations*)**

Internal Revenue Code § 280C (a) requires taxpayers claiming a tax credit under IRC §§ 45A(a), 45P(a), 51(a), 1396(a), 1400P(b) and 1400R to reduce the deduction for wages by the sum of the credits claimed. The definition of “Net Income” in M.G.L. c. 63 §30.4 explicitly allows taxpayers to take an additional deduction for that portion of wages not deducted federally because of the §51 credit. Taxpayers claiming this particular credit (the other sections listed in IRC §280C (a) address credits for wages paid to members of Indian tribes, wages paid to active duty Military, and obsolete provisions related to Hurricane Katrina) file form 5884 with their federal return. The additional Massachusetts deduction applies only to the amount of federally disallowed deductions attributable to the general wage credit under IRC §51.

#### **State & Municipal Bond Interest**

Internal Revenue Code § 103 excludes interest on certain state and local bonds from federal gross income, but this interest is included in Massachusetts gross income under M.G.L. c. 63, § 30.3. In

a proper book to tax reconciliation this will show up on either schedule M-1 or M-3. Note that the presence of tax-exempt bonds as an asset on the taxpayer's balance sheet may also trigger an investigation.

### **Section 168(k) Bonus Depreciation Adjustment**

Internal Revenue Code § 168(k), enacted after the September 11<sup>th</sup> attacks, allows taxpayers to take a special depreciation allowance on certain property in the year in which it is placed in service. The adjusted basis of the property is reduced by the amount of the special allowance, and additional depreciation is calculated on the reduced amount for federal income tax purposes. The amount of the special allowance and the period in which the property must be placed in service has varied over the years. Massachusetts does not allow the deduction under IRC § 168(k), but instead requires taxpayers to recalculate their depreciation on those assets as if IRC § 168(k) did not exist. See [TIR 02-11](#). The adjustment on this line may be positive or negative. See [TIR 03-25: \*Depreciable Business Assets; Modifications For Decoupling From Federal Bonus Depreciation\*](#), for modifications necessary for Massachusetts gain or loss if IRC § 168(k) assets are disposed.

If the taxpayer has failed to add back current year bonus depreciation, Massachusetts net income may be understated or overstated. The amount for federal purposes is reported on IRS Form 4562.

### **Foreign, State or Local Income, Franchise and Capital Stock Taxes**

Taxes on or measured by income, franchise taxes measured by net income, franchise taxes for the privilege of doing business and capital stock taxes imposed by any state are not deductible. Note that "state" includes any territory or possession of the United States and any foreign country. Any deductions taken for these taxes federally are included in the federal net income figures used as the basis on various Massachusetts returns and must be "added back" in computing Massachusetts net income. This includes taxes on:

- (1) A corporation's income, whether net or gross, or are imposed directly on or are measured by income.
- (2) A corporation's business activity (the privilege of doing business); or
- (3) A corporation's business wealth (capital stock taxes).

Note that while deduction for a margin tax imposed for the privilege of doing business is disallowed (see [DD 08-7](#)), taxes on discrete events (Sales taxes, the New York City Commercial Rent or Occupancy Tax, payroll taxes, local property taxes etc.) remain deductible to the extent they are deductible under the Code. See [DD 99-9](#).

The Federal Form 1120 and Form 1120S Corporation tax returns include a specific line for taxes, which may include some taxes that Massachusetts requires be added back. The taxpayer should be prepared to provide a schedule breaking out these amounts. In addition, non-deductible taxes paid by lower-tier entities (if any) must be identified and added back. If the taxpayer has lumped distributive share income from partnerships together in other income (a common practice), the original K-1 or equivalent document may show taxes as separately stated items.

### **Interest or Intangible Expense Addbacks**

Massachusetts disallows most deductions for interest and/or intangible expenses paid or accrued to a "related member" as defined in M.G.L. c. 63, § 31I even if that expense is deductible under the Code. A "related member" within the meaning of the addback statute is a person who is:

- 1) a related entity (including an individual) owning at least 50% of the value the corporation, with attribution of ownership among related parties under section 318 of the Code,

- 2) a component member as defined subsection (b) of section 1563 of the Code,
- 3) a person to or from whom there is attribution of stock ownership in accordance with subsection (e) of section 1563 of the Code, or
- 4) a person that, notwithstanding its form of organization, bears the same relationship to the taxpayer as a person described in (1) to (3), inclusive.

In addition, under M.G.L. c. 63, § 31J(c), interest paid to someone who is not a related member is not deductible if paid in connection with a debt incurred to acquire the taxpayer's assets or stock in a transaction that is referenced in section 368 of the Internal Revenue Code. Also, M.G.L. c. 63, § 30.4 (v) (applicable to business corporations and non-financial S corporations only) disallows interest paid on a note distributed to a shareholder as a dividend except as provided under § 31J (that subsection also does not require that the recipient of the interest be a related member.)

With respect to royalties two additional considerations apply:

(i) Purchases of tangible property from an affiliate where the purchase price includes an embedded royalty may include a related-member royalty component subject to the addback provisions (see [830 CMR 63.31.1\(3\)\(a\)](#)). Where the price paid for the property includes such a royalty, the amount should be reported by the taxpayer as an addback subject to a taxpayer claim for exception. *Auditors should be alert for this scenario, especially where the taxpayer uses an overseas contract manufacturer (whether or not affiliated) that may be paying royalties for the use of Intellectual Property that is owned by an affiliate of the taxpayer.*

(ii) Amortization of intangibles under IRC § 197 is subject to the addback if the intangibles were purchased from a related member. Again, this is subject to a taxpayer claim for exception. [See DD 07-9.](#)

The mechanics of the corporate returns require taxpayers to report the existence and amount of deductions for such expenses even if they are deductible under c. 63, unless both the member deducting the expense and the member receiving the income are participating together in a combined report and the deduction has been properly eliminated prior to the addback. Where the taxpayer has reported an addback, the auditor should request detail on the expense and the calculation of the amount even if no exception has been claimed (without this detail, if a related member expense is identified during the audit, it will not be evident if that amount was included in the addback). In all cases, the addback should be limited by the amount actually deducted on the federal return. If a deduction was reduced under the Code the reduced amount is added back. If the current year deduction includes amounts denied federally in prior years the addback requirement similarly includes those amounts.

Regardless of whether an addback was reported, there may be evidence of a related member expense in (a) the trial balance, (b) the financial statements and accompanying notes, (c) federal returns notably form 5472, or (d) current or prior Massachusetts returns (either through the prior filing of an addback schedule or the disclosure of related member debt). In addition, the auditor should determine the recipient of any interest deducted by the taxpayer and the origin of the underlying debt (is it either a dividend not or a debt incurred to acquire the taxpayer's assets or stock in a transaction that is referenced in section 368 of the Internal Revenue Code.)

Taxpayer claims for exceptions (deductions for some or all of the disallowed expense) are handled individually based on the facts and circumstances of each claim. Particularly with respect to interest expense paid or accrued to a related party, the investigation may involve:

- 1) debt/equity issues;
- 2) limitations on deductions (including timing rules) under various section of the Code; and

- 3) application of M.G.L. c. 63 §§ 31I - 31K even if the amount is presumed to be deductible under the Code.

The addback regulation ([830 CMR 63.31.1](#)) provides numerous examples of when an exception should or should not be allowed. A sample IDR for a related member interest expense is shown in the [Appendix](#). A sample IDR for a related member intangible expense is shown in [Appendix](#).

### **Federal Production Activity Deduction Addback**

Massachusetts disallows the Federal Production Activity deduction allowed by IRC § 199. While this is typically reported as a separate line item on the US Form 1120, it may be buried with other partnership items if it is part of a corporation's distributive share of income. A review of the Schedules K-1 used to prepare the corporation's return should show this as a separately stated item.

### **Massachusetts R&D Credit Addback**

M.G.L. c. 63 § 38M (b) requires taxpayers to reduce their deductions for research expenses by the amount of any research credit claimed under § 38M, and a taxpayer who files schedule RC to claim a credit with respect to expenses in the current year should have an adjustment on this line equal to the current year credit generated and not the amount of credit taken against excise. A similar provision exists for the Life Science research credit under chapter 63 § 38W.

Taxpayers claiming the federal research credit under IRC § 41 are required under IRC § 280C to make a similar reduction in their deductions allowable for federal income tax purposes unless they *elect* to claim the credit at a reduced rate. Because M.G.L. c. 63, § 38M (b) also states that the 280C adjustment will not apply, taxpayers who did not make the reduced rate election may have combined the 2 adjustments into a single figure.

### **Dividends Received Deduction (DRD)**

Massachusetts allows business corporations and financial institutions a deduction for 95% of dividends (exclusive of distributions in liquidation) received, other than:

- (i) Dividends out of tax free earnings of a corporate trust as defined in M.G.L. c. 62 as in effect on December 31, 2008 (earnings on which the corporate trust had not paid a tax were taxable as dividends to the recipient when distributed. These entities were required to conform to their federal classification for Massachusetts tax purposes effective January 1, 2009. See 830 CMR 63.30.3 for transition rules);
- (ii) Dividends (except actual distributions out of previously taxed income) from a DISC that is not wholly owned (income of a DISC that is wholly owned is treated as income of the parent under M.G.L. c. 63, § 38G); and
- (iii) Dividends received from corporations in which the receiving corporation does not own at least 15% of the voting stock of the corporation paying the dividend. Note that in M.G.L. c. 63, § 30.4, distributions received directly or indirectly from a REIT (Real Estate Investment Trust) or a RIC (Regulated Investment Company) are excluded from eligibility for the dividends received deduction regardless of the ownership percentage. (see [Technical Information Release 04-10](#)).

Pre-2014 Utility Corporations were not eligible for the MA DRD (to avoid double taxation, the

definition of “Net Income” used in the former § 52A excluded from income 100% of dividends received from other utility corporations if the taxpayer owned 80% of the voting stock of that other utility corporation).

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### **Federal Work Opportunity Credit and MLSC-Authorized Orphan Drug Credit Deductions**

There are instances where a taxpayer is allowed to take a business expense deduction for which there is a federal credit but no corresponding deduction at the federal level:

(i) Federal Work Opportunity Credit - Massachusetts law has allowed a corporation to deduct the portion of wages or salary used to calculate the federal work opportunity credit under IRC § 51 (G.L. c. 63, § 30.4)

(ii) MLSC-Authorized Orphan Drug Credit – as part of the life sciences initiative passed in 2008, Massachusetts law permits a corporation that takes the federal credit for clinical testing expenses in the pharmaceuticals industry (the “Orphan Drug” credit, see IRC § 45C) to deduct the amount of the credit from the Massachusetts corporate excise when specifically granted the benefit by the Massachusetts Life Sciences Center. G.L. c. 63, § 38V.

See [Department Directive 14-4 \(Item IV\)](#).

### **Other Adjustments (this list is not intended to be exhaustive)**

Capital loss carryovers - M.G.L. c. 63 § 1, § 30.4, and the former § 52A all prohibit deductions for losses sustained in other taxable years. Note that while a federal net operating loss is deducted at the end of the taxable income calculation, a capital loss carryover is included in the federal schedule D computations and, if present, must be backed out on the Massachusetts return.

Basis Adjustments – M.G.L. c. 63 § 31M requires that corporations determining gross income must adjust any item of gain or loss included in federal gross income to reflect applicable differences in the Massachusetts and federal tax rules over the life of an asset that should, in principle, give rise to differences in basis. This includes, without limitation, adjustment to the federal basis of shares in a business corporation that was formerly treated as a corporate trust. This may also apply in other situations where, prior to 2009, there was a difference between Massachusetts and federal entity classification, or in any scenario where a federal provision affecting the calculation of basis was not applicable under chapter 63 during the year in which the federal basis adjustment was triggered. One common scenario is where the federal basis has been adjusted for depreciation expense and the deduction is different under Massachusetts law.

Deductions disallowed federally - Financial institutions (but not business corporations or pre-2014 utility corporations) may take deductions that would otherwise qualify except that they are disallowed federally under IRC § 291, and may also take deductions (again, if otherwise qualified) that are disallowed under IRC § 171(a)2 and § 265 to the extent the income from the tax exempt bonds relates to interest income included in (i.e. added to federal gross income to determine) Massachusetts gross income.

Additional deductions under Massachusetts law – Certain provisions of Chapter 63 allow taxpayers to take a deduction in addition to the deduction allowed federally (See c. 63, §§ 38F, 38I, 38J, 38O related to wages in a poverty area, wages subject to the federal wage credit if paid for work in Massachusetts, qualified research contributions to a Massachusetts educational institution and renovation of abandoned buildings in an economic opportunity area). Note that the first 3 deductions are limited to business corporations and that the § 38I deduction is in

addition to reversing the IRC § 280C (a) but applies only if the wages were paid in this commonwealth and is not available if the § 38F deduction is claimed for the same wages.

Timing differences – Similar to the “bonus depreciation” adjustment which may be positive or negative, certain provisions of Chapter 63 explicitly require taxpayers to recognize income or allow taxpayers to take deductions on a schedule different than that provided for in the Code. Examples include:

(i) Taxpayers determine Massachusetts gross income without regard to IRC § 108(i) (an income deferral provision which allowed taxpayers who reacquired their own debt in 2009 and 2010 to defer recognition of the cancellation of debt income).

(ii) Business corporations may deduct (i.e. expense rather than depreciate) costs of a solar- or wind-powered climatic control or water heating unit under M.G.L. c. 63 § 38H, but must then forgo the depreciation deductions allowed federally for the capitalized total of those expenses.

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### 9.3.5 Income Verification Checklist

The following steps should be taken as a starting point in verifying each corporation's taxable net income (auditors are required to follow-up as appropriate):

- ✓ Review the taxpayer’s financial statement and, if appropriate, the trial balance. If taxpayer is a publicly traded entity with operations outside the US, a reconciliation of book income per the tax return to worldwide income as shown in taxpayer’s Form 10-K (Annual Report) as filed with the US Securities and Exchange Commission (SEC) should also be reviewed. Historical information may identify issues (e.g. a leveraged acquisition may result in an addback issue under M.G.L. c. 63, s. 31J).
- ✓ Review book-to-tax work papers and Form 1120 Schedule M-1 or M-3. Confirm that book income corresponds to the financial statements. Determine which adjustments to review in detail. Carryovers for capital losses and charitable contributions should be noted as should non-taxable interest income.
- ✓ Review the federal income tax return - both to identify potential issues and to verify that the taxpayer has properly transferred the net income from that return to Schedule E. Note that the review of the federal return may take several days and should include a review of statements attached to the federal return.
- ✓ Review any IRS Revenue Agent Report (RAR) or other record of federal audit changes for the periods being audited, and for any periods generating carryovers into or through the audit period.
- ✓ Review capital gains and losses - even if there is no entry on line 8 of the federal return. If the taxpayer participates in a consolidated federal return, review the consolidation schedules for the federal Schedule D.
- ✓ Review gains and losses on federal Schedule 4797 for proper treatment. If the taxpayer shows a large schedule 4797 loss, verify that the taxpayer is not reporting capital losses as losses on the sale of business property.
- ✓ Review taxpayer’s calculation of federal tax depreciation and Form 4562 from the federal return. In addition to checking for a Section 168 (k) deduction, a significant increase in amortizable assets may be an issue for further review (an acquisition of a business or intellectual property may be appropriate).
- ✓ Review the Massachusetts return - verify the taxpayer's determination that certain income is not

subject to apportionment.

- ✓ Verify that the taxpayer has added back (i) federal deductions for state and local income taxes, (ii) the production activities deduction under Section 199 of the Internal Revenue Code, and (iii) an amount equal to the research credit generated in the current year (if applicable).
- ✓ Review interest and intangible expenses from the trial balance, the federal return and/or Massachusetts addback exception claims. An audit of a corporation claiming a deduction for related party interest or intangible expenses will include an evaluation of the taxpayer's claim.
- ✓ Review any dividends received deductions (DRDs). Verify that they come from an eligible source if the DRD is claimed.
- ✓ Review any and all favorable adjustments on the Schedule E - both for the legal basis and the amounts reported.
- ✓

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#### **9.4 Corporate or Financial Institution Income Apportionment**

If the corporate taxpayer is not taxable in another state, 100% of its taxable net income will be taxed in Massachusetts. If the taxpayer does not have offices or employees in another state this *may* be the case, and if the taxpayer has not allocated all of its income to Massachusetts the auditor should investigate whether or not it has nexus in any other state. Such a review typically begins with an IDR request that the taxpayer identify the other state or states with which it believes it has nexus. A corporation that does not have offices or employees in a state may still have nexus there depending on its activities (see Section 9.5 on Corporate Nexus).

Corporations with income from business activity that is taxable both in Massachusetts and in other states are required to apportion their income from the multi-state business before calculating the income measure of excise. This is required under the U.S. Constitution, and therefore applies equally to Financial Institutions, Business Corporations and pre-2014 Utility Corporations. The formulas applicable and the factors used vary depending on the type of business and its activities during the taxable year. For business corporations, the apportionment formula is also used in calculating the non-income measure.

This procedure provides an overview of the formulas involved and the methods suggested when beginning an audit. The focus is on the Chapter 63 § 38 provisions applicable to both business corporations and pre-2014 utility corporations. Differences specific to Financial Institutions are highlighted after the discussion of each apportionment factor.

Special rules apply in the context of combined reporting: see 830 CMR 63.32B.2(7) and Chapter 10 Combined Reporting.

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##### **9.4.1 Allocable Income**

If a corporation does not have income from business activity which is taxable in another state, the whole of its taxable net income shall be allocated to the commonwealth. This point applies to Financial Institutions as provided in [M.G.L. c. 63 § 2A\(a\)](#), to Business Corporations as provided in [M.G.L. c. 63, § 38\(b\)](#), and to pre-2014 Utility Corporations under the former [M.G.L. c. 63 § 52A \(2\) and \(3\)](#). Both § 2A and § 38 (note that the former § 52A(3) directed the reader to § 38) provide that if the corporation *does* have income taxable in another state but *also has* income that is

taxable only in the state of domicile, the full amount of the latter is allocated to Massachusetts if this is the taxpayer's domicile. Identifying income allocable to Massachusetts may have significant tax consequences, particularly where the taxpayer's apportionment percentage for its business income is low. For example:

Full Apportionment w/Allocable Income		
Taxable Net Income	5,000,000	5,000,000
Remove Allocable Amount	--	(2,000,000)
Income subject to Apportionment	5,000,000	3,000,000
Apportioned to Massachusetts @ 20%	1,000,000	600,000
Allocable Amount @ 100%	--	2,000,000
Taxable Net Income allocated/apportioned to MA	1,000,000	2,600,000
Tax @ 8%	80,000	208,000

Where the taxpayer is not domiciled in Massachusetts, a taxpayer's claim that income is allocable (to some other state) may also merit investigation, even if the effective apportionment to Massachusetts is relatively small. This is especially true given that audits of non-Massachusetts corporations often focus on the very large taxpayers.

w/ Income Excluded Full Apportionment (allocated to another state) (no separate allocation)		
Taxable Net Income	70,000,000	70,000,000
Amount allocated to some other state	(60,000,000)	--
Income subject to Apportionment	10,000,000	70,000,000
Apportioned to Massachusetts @ 4%	400,000	2,800,000
Tax @ 8%	32,000	224,000

A non-domiciliary state may tax income from business activity within its borders, but it may not tax other income the same taxpayer may have if that other income is unrelated to the business activity the state has jurisdiction to tax. The unitary business concept is applicable across a group of related taxpayers to determine if a combined report is required and as to which corporations, but also must be considered in the context of the activities of a single corporation.

Massachusetts has not sought to narrow the scope of what is unitary in the context of a multistate business, but there are limits to this concept under the U.S. Constitution. In addition to reviewing a corporation's separate return and activities, income from long-term investments in other businesses that are unrelated to the taxpayer's own multi-state business are most likely to warrant audit review. Two U.S. Supreme Court cases to be aware of here are *Allied-Signal v. Director Division of Taxation*, 112 S.Ct. 2251 (1992) and *Mead Westvaco Corp v. Illinois Department of Revenue*, 128 S.Ct. 1498 (2008).

In *Allied-Signal*, the Court agreed with the taxpayer that the gain realized from its sale of a 20% interest in Asarco (whose business was not unitary with the taxpayer's own manufacturing business) was not subject to taxation by New Jersey even though (a) the taxpayer was represented on Asarco's board while it held the investment and (b) the investment in Asarco was part of a long-term strategy of investments and divestitures and the funds realized from the sale could have been (were intended to be) used to acquire another business that might have become unitary with the taxpayer's. The taxpayer was domiciled in Michigan, so New Jersey could not tax this gain.

In *Mead Westvaco*, the Court agreed with the taxpayer that a capital gain realized from its sale of a 100% owned subsidiary Lexis was not subject to taxation in Illinois in spite of a finding by the trial court that owning Lexis served an operational purpose for Mead, where the same trial court had also found the 2 businesses were not unitary. Absent a unitary relationship between the businesses, Illinois could not tax the gain realized by Mead, which was domiciled in Ohio (note that although the trial court had found the businesses of the two corporations were not unitary, that issue was not before the Supreme Court – it had been reserved by the Illinois appellate court which considered that the finding of an operational purpose for the investment was sufficient to allow Illinois to tax the gain – that position of the Illinois appeals court (that operational purpose was sufficient by itself as opposed to merely being a factor in a unitary analysis) was rejected by the Supreme Court, reinforcing that the two businesses had to be unitary for a non-domiciliary state to tax the gain).

In reviewing the return of a corporation that is domiciled outside of Massachusetts, the auditor should make inquiries about any income excluded from the Massachusetts return, including, in the case of an asset sale, the history of the asset sold and the reasons for the investment and its sale. While the two cases cited above both concluded that the gain in question was not apportionable, the facts of each case matter and, except where the income derives from a minority stake in a limited partnership, the presumption is that all the income of a corporate taxpayer is unitary, and the burden of proof is on the party asserting that an item of income is not derived from the conduct of a multistate business. See [830 CMR 63.38.1 \(3\) & \(4\)](#).

In reviewing the return of a corporation that does have its commercial domicile in Massachusetts, if the auditor identifies income that might be allocable, the review should normally include how the transaction was treated on returns filed in other states, bearing in mind that some of those other states may have chosen to not tax some transactions (e.g., the sale of a business) as a matter of policy.

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#### **9.4.2 Three Factor Apportionment**

[M.G.L. c. 63, § 38\(c\)](#) provides a formula to determine the part of a corporation's taxable net income subject to apportionment that is subject to tax in Massachusetts. This standard formula uses 3 factors – property, payroll and sales. Each factor is calculated as a ratio, dividing the portion of the attribute in Massachusetts by the worldwide total. For most business corporations, the final apportionment percentage is determined by taking an average with the sales factor being double weighted:

(Property Factor + Payroll Factor + (2 x Sales Factor))

4

By convention, each of the three factors and the resulting weighted average are carried to 6 decimal places (e.g. 0.373456 or 37.3456%). Some taxpayers have used 8 decimal places in prior years.

If any factor is inapplicable (e.g. the taxpayer has no payroll worldwide), the apportionment percentage is calculated based on the remaining factors with the denominator reduced to reflect the weights of the factors less any factors that do not apply. The regulation ([830 CMR 63.38.1\(11\)](#)) includes a formula calculation that compares the taxable net income to be apportioned to the denominator of each factor. A result of less than 1/30 (approximately

0.033333) results in the factor being considered inapplicable regardless of the numerator. For example:

$$\frac{\text{Wage Factor Denominator} = \$50,000}{\text{Taxable Net Income} = \$2,500,000} = 0.02 \dots \text{The payroll factor is inapplicable since less than } 1/30$$

Note that the commissioner may also determine that a given factor is not significant in producing income for reasons other than the ratio test. Any such determination will rely on the specific facts of the case.

Apportionment calculations generally include all the property, payroll and sales of the taxpayer. However, in the case of a taxpayer with gross income that is excluded from federal gross income, gross receipts, property and payroll to which that income is attributable are excluded from the numerator and denominator of the payroll factor (see 830 CMR 63.38.1(9)(e)). This scenario most commonly applies in the case of a foreign corporation that excludes non-US source income from federal gross income and thus also from Massachusetts gross income.

#### **Utility Corporation Apportionment**

A pre-2014 utility corporation uses the M.G.L. c. 63 § 38 procedure but with a single-weighted sales factor and a denominator of three instead of four. For these years, there is generally no difference in the calculation of the factors. Post-2014 utility corporations are required to calculate apportionment with a double-weighted sales factor.

#### **Financial Institution Apportionment**

A financial institution determines its net income taxable in Massachusetts under [M.G.L. c. 63 § 2A](#). That section provides for the allocation of income not taxable in any other state to Massachusetts and for the apportionment of the income that is subject to apportionment using a three factor formula using receipts, property and payroll with the 3 factors equally weighted (divide by three instead of four). A factor is omitted from the calculation only if the *denominator* for the factor is zero. The calculation of the receipts factor and the property factor by a financial institution are slightly different than the calculation of the sales factor and the property factor by a business corporation (see below).

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### **9.4.3 The Property Factor**

The property factor is a fraction, the numerator of which is the average value of the corporation's real and tangible property used in this commonwealth during the taxable year and the denominator is the average value of the corporation's real and tangible property used worldwide. Property owned is valued at original cost (ignoring depreciation and other reserves) and the average value of owned property is normally a simple average of the values at the beginning of the year and the end of the year (an average of monthly values may be used if required to accurately reflect the average value of property in use). Property rented is valued at 8 x the net annual rental rate.

Property includible in the denominator, whether owned or rented, is also includible in the numerator if the physical location where the property is used is within Massachusetts.

Special considerations in calculating the property factor include:

- ✓ Property or equipment under construction (not yet placed in service) is excluded from the property factor except for a construction company to the extent the work completed exceeds progress payments received;

- ✓ Property in transit is considered to be at its destination for apportionment purposes;
- ✓ Mobile property may be allocated by the taxpayer using any reasonable method, but once a method is adopted for a particular type of mobile property it may not be changed in subsequent years without the approval of the commissioner;
- ✓ Property leased to another is owned by the taxpayer for apportionment purposes if the transaction is treated as a lease, not a sale, for federal tax purposes;
- ✓ Consigned inventory that is owned by the taxpayer is included in the property factor;
- ✓ Net annual rent includes amounts paid as additional rent or in lieu of rent under the rental agreement for property taxes, insurance, etc. less the value of any bona fide services received; and
- ✓ Net annual rent is the rent paid less amounts recovered through subleases but not less than that portion of the rent paid allocable to the portion of the property not subleased.

The apportionment regulation addresses property factor issues at 830 CMR 63.38.1(7).

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### **Financial Institution Property Factor**

Financial Institutions include the value of loans and credit card receivables (in addition to the value of real and tangible property that is owned or rented) when calculating the property factor. Loans and credit card receivables are valued at their outstanding principal balance, without regard to any reserve for bad debts. Loans or credit card receivables that have actually been “charged off” for federal income tax purposes are excluded to the extent they have been charged off. A specifically allocated reserve established pursuant to regulatory or financial accounting guidelines which is treated as charged-off for federal income tax purposes shall be treated as charged-off for apportionment purposes.

Loans and credit card receivables includible in the denominator of the property factor are also includible in the numerator if they are properly assigned to a regular place of business of the taxpayer within this commonwealth.

Each loan (or each credit card receivable) is properly assigned by the taxpayer to a regular place of business based on the preponderance of the substantive contacts. Substantive contacts are taxpayer’s employees in performing the functions listed below. These contacts are attributed to the taxpayer’s regular place of business that the taxpayer’s employee is connected with or working out of, regardless of where the activity occurs:

- (1) “Solicitation” may include both contacts initiated by employees of the taxpayer (active solicitations attributed to the regular place of business the employee is connected with or working out of) and contacts initiated by the customer (passive solicitations attributed to the regular place of business where the contact occurred or to where the passive solicitation occurred).
- (2) “Investigation” includes activities determining the credit-worthiness of the customer and the degree of risk involved in making the loan.
- (3) “Negotiation” includes contacts between employees of the taxpayer and the customer to determine the terms of the loan.
- (4) “Approval” is the procedure whereby employees of the taxpayer make the final determination to enter into the agreement. If the board of directors makes the final determination, this is deemed to occur at the commercial domicile of the

taxpayer.

- (5) "Administration" is the process of managing the account including bookkeeping, collecting the payments, corresponding with the customer, reporting to management regarding the status of the agreement and proceeding against the borrower or the security interest if the borrower is in default.

The taxpayer's assignment of a loan (or credit card receivable) to a place of business outside of Massachusetts is presumptively correct if:

- (a) The taxpayer has assigned, in the regular course of its business, such loan on its records to a regular place of business consistent with federal or state regulatory requirements;
- (b) Such assignment on its records is based on substantive contacts of the loan to such regular place of business; and
- (c) The taxpayer uses said records reflecting assignment of loans for the filing of all state and local tax returns for which an assignment of loans to a regular place of business is required.

The presumption may be rebutted by showing that the preponderance of substantive contacts regarding the loan did not occur at the place to which the loan was assigned. Once the taxpayer's assignment of the loan has been shown to be incorrect, the loan will be assigned to the commonwealth if (a) the taxpayer had a regular place of business within the commonwealth at the time the loan was made and (b) the taxpayer fails to show that the preponderance of substantive contacts did not occur in Massachusetts.

Per [M.G.L. c. 63 § 2A](#), where a loan has been properly assigned to a state (absent any change of material fact), that loan remains assigned to that state for the length of the original loan term (after which it may be assigned to another state based on the preponderance of substantive contacts).

Financial Institutions may, at their option, determine average property owned (including loan property) using amounts calculated more frequently than the beginning and end of the taxable year. The commissioner also has the option to require more frequent averaging.

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#### **9.4.4 The Payroll Factor**

The payroll factor is a fraction, the numerator of which is the total amount paid for compensation in the commonwealth and the denominator of which is the total paid for compensation worldwide. Compensation for this purpose includes wages, salaries, commissions, and any other form of remuneration paid to employees for personal services provided. The figures used in the apportionment calculations are those used in reporting for unemployment compensation purposes.

Special considerations in calculating the payroll factor include the following:

- ✓ Taxpayers may elect to use the accrual method instead of wages paid in calculating the payroll factor. Once an election to do this has been made, it may not be revoked without the approval of the commissioner.
- ✓ Amounts paid to non-employees (including contractors and employees of a temporary staffing agency providing services to the taxpayer) are not included in the payroll factor calculation but leased employees are. Amounts paid to employees for services performed may include amounts reported on 1099 forms in addition to amounts reported on W-2 forms;
- ✓ Compensation is considered to be paid in Massachusetts (and is therefore included in the numerator) if some of the employee's service is performed in Massachusetts, and either:

- (a) the employee's base of operations is in Massachusetts,
- (b) there is no base of operations and the employee's service is directed and controlled from Massachusetts, or
- (c) the employee's residence is in Massachusetts and the employee does not perform services in either the state where his base of operations is located or the state from which his service is directed and controlled.

A "base of operations" for this purpose is defined in the regulation as a taxpayer's place of business and is not the employee's home. Wages paid to employees who typically work out of their homes may be includible in the numerator if some of their services are performed in Massachusetts.

- ✓ Leased employees are included in the payroll factor of the corporation to which they provide services and are not included in the payroll factor of the leasing company; and
- ✓ The commissioner may require employees working for a member of an affiliated group (as defined in Section 1504 of the Internal Revenue Code) to be included in the payroll factor of the group member for which they actually perform the greatest portion of their services.

The apportionment regulation addresses property factor issues at 830 CMR 63.38.1(8)

#### **Financial Institution Payroll Factor**

Financial Institutions calculate the Payroll factor under [M.G.L. c. 63 § 2A \(f\)](#). These provisions mirror those described above, although there is no explicit authority to (a) use the accrual method, (b) include leased employees in the payroll factor or (c) attribute wages paid by a common paymaster within a federal affiliated group to the group member for whom they provide services.

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#### **9.4.5 The Sales Factor**

The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in Massachusetts and the denominator of which is the total sales worldwide. The general rule is that sales include all gross receipts of the taxpayer except (see 830 CMR 63.38.1(9)(a)):

1. Interest;
2. Dividends;
3. Gross receipts from the maturity, redemption, sale, exchange, or other disposition of securities as defined at 830 CMR 63.38.1(2);
4. Gross receipts from the sale of business "good will" or similar intangible value, including without limitation, "going concern value" or "workforce in place" (i.e., in the case of a sale or deemed sale of a business); and
5. Gross receipts that result in an allocable item of income, irrespective as to whether that allocable item of income is allocated to Massachusetts.

Each of the above exclusions is specifically mentioned at one point or another in M.G.L. c. 63, § 38(f). Also in that subsection, the statute provides that, in the case of the sale of a capital asset used in the taxpayer's business, receipts are measured by the gain from the transaction (instead of the gross sales price). The auditor should request specific detail because the amount reflected on the 1120 return as the capital gain on the sale of capital assets may be inclusive of multiple assets. Other, less common statutory provisions may require further research as they are encountered on audit.

In determining which sales should be included in the numerator, sales are divided into sales of tangible property and all other sales. Taxpayers and auditors should be aware that some sales records in the taxpayer's accounting system may include both types of sales. The auditor should closely review the 1120 return, specifically the "Other Deductions" as reported (i.e. receipts from management fees or other income may be found here). In some cases the application of different sourcing rules based on whether a receipt is from the sale tangible property or something else may require the auditor to carefully consider how the taxpayer has classified its sales.

### **Sales of Tangible Property**

Sales of tangible personal property are in this commonwealth if they are delivered to a purchaser in this commonwealth regardless of FOB point or other conditions of the sale. Sales of tangible personal property delivered to purchasers in other states are "sales in this commonwealth" for apportionment if (a) the corporation is not taxable in the state of the purchaser and (b) the property was not sold by an agent of the taxpayer chiefly situated at, connected with or sent out from the taxpayer's owned or rented business premises outside of Massachusetts (this is the "throwback rule"). For purposes of applying the throwback rule, the taxpayer is deemed to be taxable in any foreign country to which it has sales. Auditors should consider the specific provisions and examples set forth at 830 CMR 63.38.1(5).

### **Sales of other than Sales of Tangible Property**

A statutory change effective January 1, 2014 modified the sourcing rules for "Sales other than sales of tangible property" from one requiring a review of where the income producing activity occurred (if more of this in terms of cost was done in Massachusetts than in any single other state, the sale was in Massachusetts) to the market. Under both the old and the new rules, receipts for the licensing of intangible property are attributed to Massachusetts to the extent the property is used in this commonwealth. The regulation [830 CMR 63.38.1](#) is available on DOR's external website and includes numerous examples.

The prior version of the apportionment regulation, applicable to taxable years beginning prior to 1/1/2014 is available internally in the [Appendix](#). Note that this version of the regulation was promulgated in 2006 and was superseded in a few areas by a statutory change (e.g., the exclusion of receipts from the sale of goodwill from the sales factor was a statutory change made in 2008 – this change was not noted in the regulation until the 2014 revision).

In general, the provisions of [830 CMR 63.38.1\(9\)\(d\)4-7](#) establish uniform rules for (1) determining whether and to what extent the market for a sale other than the sale of tangible personal property is in Massachusetts, (2) reasonably approximating the state or states of assignment where such state or states cannot be determined, and (3) excluding the sale where the state or states of assignment cannot be determined or reasonably approximated. Rules are to be applied sequentially in a hierarchy. The taxpayer only moves to the 2<sup>nd</sup> rule when assigning a sale if they cannot determine the correct state under the primary rule after making a good faith effort to do so.

Note that under the "throw out rule" it is insufficient to identify only whether or not the sale is includible in the numerator. If the taxpayer is not taxable in the state to which the sale is attributed it is also excluded from the denominator of the sales factor. Similarly, if the state to which the sale is attributable cannot be determined or reasonably approximated, the sale will also be excluded from the denominator.

In greatly abbreviated form (please refer to [the current apportionment regulation](#) for necessary clarifications prior to constructing an IDR or applying a response) the various categories of receipts and general rules are;

**Real Property** – Receipts from the sale, rental, lease or license of real property are attributed to the location of the real property (830 CMR 63.38.1(9)(d)2.)

**Tangible Property** – Receipts from the rental, lease or license of tangible property are attributed to the location of the property. For mobile property, receipts are attributed to Massachusetts in the same proportion that applies for property factor purposes. (830 CMR 63.38.1(9)(d)3.)

**Special Rules: Software** – A license or sale of pre-written software for purposes other than commercial reproduction (or other exploitation of the intellectual property rights), when transferred on a tangible medium, is treated as a sale of tangible property. In all other cases, the sale of software is sourced under the rule that best reflects the facts of the actual transaction (it may be a service, a marketing intangible, a production intangible, a sale of goods or service, or sale of intangible property.)

**Special Rules: Sales or License of Digital Goods or Services** – In the case of a sale or license of digital goods or services, including, among other things, the sale of various video, audio or software products, the receipts are assigned under the rules for sales of services. The terms of the contract are not relevant.

**Special Rules: Enforcement of Legal Rights** – Receipts attributable to the protection or enforcement of legal rights of the taxpayer through litigation, arbitration or settlement of legal disputes or claims are excluded from the numerator and the denominator of the sales factor. In the case of a settlement, it is not relevant how the parties to the agreement characterize the payment made under the agreement.

**Intangible Property (830 CMR 63.38.1(9)(d)5-6)** – receipts from licensing (or leasing) intangible property are sourced to Massachusetts to the extent the intangible is used in Massachusetts. In general the term “use” refers to the location of the taxpayer’s market for the use of the property and not the location of the taxpayer’s property or payroll as otherwise determined for apportionment purposes. Receipts from the sale of intangible property are sourced to a state to the extent the right to use the intangible is attributable to that state (but in cases where this determination cannot be made, such receipts are thrown out). The nominal description of the transfer (license or sale) is not determinative. An agreement that provides for payments contingent upon the productivity, use or disposition of the property is sourced as license. An agreement that conveys all substantial rights in the intangible property in exchange for payment that is not contingent upon use is treated as a sale. In either case, receipts from the transfer of “goodwill,” “going concern value” or “workforce in place” or similar items are excluded from the sales factor.

Marketing Intangibles – receipts from licensing marketing intangibles are sourced to Massachusetts to the extent the fees are attributable to the sale or other provision of goods (i.e., the goods that are being marketed) to customers in Massachusetts.

Production intangibles – receipts from licensing production intangibles are sourced to Massachusetts to the extent the fees are attributable to the use of the intangible in Massachusetts.

Mixed Intangibles – receipts from licensing mixed intangibles are divided into the portion of the

fees attributable to the Marketing Intangible and the portion attributable to the Production Intangible. Provided the licensing contract separates the fees and the allocation is reasonable, it will be accepted by the Commissioner. Otherwise, the presumption is that the fees are for the Marketing Intangible.

Licenses that are in substance a sale of goods or services – where the substance of a transaction resembles the sale of electronically delivered good or service (and not a marketing or production intangible) it will be sourced under that rule (as a service.) Examples include a license of database access, a license of digital goods and a license of software that is not pre-written software. This includes the case where the customer sublicenses the property in substantially identical form including cases where it may be bundled with other property. (see 830 CMR 63.38.1(9)(d)5.e.)

Sale of a contract right or license that authorizes the holder to conduct a business activity in a specific geographic area – these receipts are sourced to a state to the extent the right is associated with that state (but in cases where this determination cannot be made, such receipts are thrown out). To the extent a portion of the receipt is assigned to a state in which the taxpayer is not taxable, the sale is excluded from the denominator of the sales factor. (see 830 CMR 63.38.1(9)(d)6.i.)

Agreement not to compete – these receipts are assigned to a state to the extent of the ratio of the state’s population is included in the area covered by the agreement to population of the U.S. geographic area covered by the agreement. To the extent a portion of the receipt is assigned to a state in which the taxpayer is not taxable, the sale is excluded from the denominator of the sales factor.

Sales of intangible property with receipts contingent on productivity, use or disposition of intangible property are sourced as a license (either marketing, production or mixed according to the facts).

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**Sales of Services (830 CMR 63.38.1(9)(d)4.)**– Receipts from sales of services are sourced based on the nature of the service, the method of delivery and in some cases, whether or not the customer is a business.

*In Person Services* – Receipts from services that are physically provided in person by the taxpayer or a third party contractor on behalf of the taxpayer are attributed to the place where the service is received. Receipts for Transportation and Delivery services are attributed in bulk (total dollars received times a ratio based on departures and arrivals for receipts from the transportation of people or pickups and deliveries for receipts from the delivery of packages). These ratios are modified to reflect only aircraft departures if the transportation or delivery service is provided exclusively by air. (830 CMR 63.38.1(9)(d)4.b.)

*Professional Services* – Receipts from professional services that are not “In Person Services” are always sourced under the approximation principle. Professional services include any that require specialized skill or knowledge, including management services, investment or brokerage services, graphic and other design services, etc. Services provided by a financial institution that, under M.G.L. c. 63 §2A are to be assigned under M.G.L. c 63 §38(f) (i.e. this section) are always sourced as “professional services.” Similarly, Receipts that qualify as “Mutual Fund Sales” under M.G.L. c. 63 § 38(m) are sourced as “professional services” but

those are attributed to Massachusetts in proportion to the interests of the shareholders in the RIC the services were provided to as described in 830 CMR 63.38.7. (see 830 CMR 63.38.1(9)(d)4.d.)

- Architectural and Engineering Services are attributed to the actual or expected location of the real estate or tangible property to which the services relate.
- For other professional services, in any year in which the taxpayer made at least 250 substantially similar service transactions and derived not more than 5% of its sales of services from any one customer, the taxpayer may use the billing address to source those sales (if the taxpayer has more than one type of professional service transaction, this safe harbor may apply to some and not all types.) Otherwise:
  - Receipts for services delivered to individuals are attributed to the state of the customer's primary residence. If the customer's primary residence cannot be reasonably identified, the billing address may be used to attribute a sale provided no more than 5% of the taxpayer's sales of services are to that customer.
  - Receipts for services delivered to businesses are attributed to the state in which the customer manages the contract. If the place from which the contract is managed cannot be reasonably identified, the billing address may be used to attribute a sale provided no more than 5% of the taxpayer's sales of services are to that customer.

*“Other” Services Delivered by Physical Means* (where the services are not in-person services and professional services, see above)– Receipts from product delivery services, direct mail services, the delivery of advertising, the on-site installation of custom software and similar transactions where the services are delivered to or on behalf of the customer are sourced to the state in which the services are delivered (e.g., if you are billed by UPS for delivering a package to Boston, that is a Massachusetts sale whether the package is delivered to you or on your behalf to a 3<sup>rd</sup> party).

*“Other” Services Delivered by Electronic Means* (where the services are not in-person services and professional services, see above) includes, without limitation, services delivered by wire, satellite transmission, audio or radio waves or other similar means. This category does not include “Professional Services” regardless of whether in that latter instance one or more documents of the professional service provider may have been delivered electronically. The sourcing rules differ slightly depending on whether the services are delivered to the customer or through or on behalf of the customer to a 3<sup>rd</sup> party:

- Receipts for services delivered electronically to an individual customer are attributed to the state in which the services are received. If the actual place of receipt is not known it should be reasonably approximated. If the taxpayer does not have other sufficient data to reasonably approximate the place where the service is received, the billing address may be used to approximate this.
- Receipts for services delivered electronically to a business customer are attributed to the state in which the services are received, which is defined as where the services are directly used by the employees or designees of the business customer. If the taxpayer cannot determine, but can reasonably approximate, the place where the service was received, it should be approximated.
  - If the taxpayer cannot determine or reasonably approximate where the service is actually received using other information, it may use the billing address of a

customer provided it engaged in at least 250 substantially similar transactions and no more than 5% of its sales of services were to that customer (the safe harbor rule).

- If the taxpayer cannot determine, reasonably approximate or does not have sufficient similar transactions to apply the safe harbor rule, it shall approximate the state or states in which the service is received using, in order, the state where the contract of sale is principally managed by the customer, then the customer's place of order and then the billing address. If the taxpayer derives more than 5% of its sales of services from a customer, the taxpayer must identify the state where the contract of sale is principally managed by the customer.

*“Other” services delivered through or on behalf of a customer* (including services delivered through a customer-intermediary to third-party recipients or services delivered directly to third party recipients on behalf of the customer) are sourced to the location of the end user or 3<sup>rd</sup> party recipient. For example, in the case of advertising, the receipts are attributed to Massachusetts to the extent the audience for the advertising is in Massachusetts. Where this cannot be determined but the location can be reasonably approximated, the location must be reasonably approximated. If a taxpayer can neither determine nor reasonably approximate the assignment location, the following secondary rules of reasonable approximation apply:

- For advertising services, the taxpayer shall approximate the portion of the audience for advertising services in Massachusetts or any state using, in order, the ratio of the number of subscribers or customers in the state to all such persons to whom the advertising is delivered (if the advertising is to a known list of persons), then the ratio of the state's population to the population of the geographic area in which the advertising is delivered.
- For services that are resold through an intermediary to end users, the taxpayer shall approximate the extent to which the service is received based on population.

### **Mutual Fund Sales**

The last part of M.G.L. c. 63 s 38(f) establishes a special rule for determining what mutual fund sales, as defined in subsection (m), should be attributed to the Commonwealth. "Mutual fund sales" in subsection (m) are taxable net income derived within the taxable year directly or indirectly from the rendering of management, distribution or administration services to a regulated investment company, including net income received directly or indirectly from trustees, sponsors and participants of employee benefit plans which have accounts in a regulated investment company. The special rule, found at the end of subsection (f), is:

M.G.L. c. 63 § 38(f) –

Notwithstanding the foregoing, mutual fund sales as defined in subsection (m), other than the sale of tangible personal property, shall be assigned to the commonwealth to the extent that shareholders of the regulated investment company are domiciled in the commonwealth as follows:

(a) by multiplying the taxpayer's total dollar amount of sales of such services on behalf of each regulated investment company by a fraction, the numerator of which shall be the average of the number of shares owned by the regulated investment company's shareholders domiciled in the commonwealth at the beginning of and at the end of the regulated investment company's taxable year that ends with or within the taxpayer's taxable year and the denominator of which

shall be the average of the number of shares owned by the regulated investment company shareholders everywhere at the beginning of and at the end of the regulated investment company's taxable year that ends with or within the taxpayer's taxable year.

(b) A separate computation shall be made to determine the sale for each regulated investment company, the sum of which shall equal the total sales assigned to the commonwealth. Prior to January 1, 2014, this rule applied only to a Mutual Fund Sales Corporation (one deriving more than 50% of its gross income from such sales) in apportioning its net income from mutual fund sales (in 2013 and prior years, the word "taxpayer" in the section of the statute read "Mutual Fund Sales Corporation".) However, for tax years beginning on or after January 1, 2014, the same rule, attributing receipts from specified services to a RIC based on the *domicile of the RIC shareholders* was extended to any corporation required to apportion. For additional information on attributing mutual fund receipts, see the section on Mutual Fund Sales Corporations (below.)

### **Financial Institution Receipts Factor**

Financial Institutions calculate the receipts factor under [M.G.L. c. 63 § 2A \(d\)](#). The receipts factor for a financial institution differs from the sales factor for business corporations principally in its inclusion of additional classes of receipts (each of which has its own sourcing rule) and the exclusion of items of gain that are not from the regular course of the financial institution's trade or business. The categories applicable to financial institutions are shown below (in each case where interest is includible, fees and penalties in the nature of interest are includible and are sourced under the same rule):

- (1) Receipts from the lease or rental of real property are in the numerator if the property is in Massachusetts.
- (2) Receipts from the lease or rental of tangible property are in the numerator if the property is in Massachusetts when it is first placed in service by the lessee (Exception - receipts for transportation property – cars, airplanes, etc. - are in the numerator to the extent the property is used in Massachusetts).
- (3) Receipts from interest on loans secured by real property are in the numerator if the property (or more than 50% of the value of such property at the time the loan was made) is located in Massachusetts.
  - ⇒ Receipts from net gains (not less than zero) on the sales of such loans are included in the numerator in the same ratio as the receipts of interest on loans secured by real property loans are actually included in the numerator to all receipts of interest on such loans.
  - ⇒ Receipts of loan servicing fees on loans owned by the taxpayer and secured by real property are also included in the numerator in the same ratio as interest on those loans.
- (4) Receipts from interest on other loans are in the numerator if the borrower is in Massachusetts.
  - ⇒ Receipts from net gains (not less than zero) on the sale of loans not secured by real property are included in the numerator in the same ratio as the receipts of interest on loans not secured by real property are actually included in the numerator to all receipts of interest on such loans.

- ⇒ Receipts of loan servicing fees on loans owned by the taxpayer and not secured by real property are also included in the numerator in the same ratio as interest on those loans.
- (5) Receipts from interest on credit card receivables and fees charged to card holders (e.g. annual fees) are in the numerator if the billing address of the card holder is in Massachusetts. Receipts from net gains (not less than zero) on the sale of credit card receivables and receipts from credit card issuer's reimbursement fees are both included in the numerator in the same ratio as the receipts of interest on credit card receivables actually included in the numerator to all such receipts
  - (6) Receipts from merchant discount are includible in the numerator if the commercial domicile of the merchant is in the commonwealth. Such receipts are net of any card holder charge backs but are not reduced by any interchange fees.
  - (7) Receipts from loan servicing fees received for servicing either the secured or unsecured loans owned by another are in the numerator if *the borrower* is located in the commonwealth.
  - (8) Receipts, other than sales of tangible property, that are not otherwise apportioned under this section are included in the numerator if they would be included in the numerator under M.G.L. c. 63 § 38(f).
  - (9) Receipts from interest, dividends, net gains (not less than zero) and other income from investment assets and activities are assigned to a regular place of business of the taxpayer and are includible in the numerator if that place of business is in Massachusetts. The place of business to which the income is assigned shall be the place where the day-to-day decisions regarding the asset or activity occurred. Where day-to-day decisions occur at more than one regular place of business, the activity is attributed to the regular place of business where the trading policies or guidelines are established (this will be presumed to occur at the commercial domicile of the taxpayer). The taxpayer has the burden of proving that an investment asset or activity or trading asset or activity was properly assigned to a regular place of business outside the commonwealth.
  - (10) All receipts, other than those sourced under the reference to M.G.L. c. 63 § 38(f), that would be assigned to a state in which the taxpayer is not taxable are included in the numerator if the taxpayer's commercial domicile is in Massachusetts.

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#### **9.4.6 Apportionment for Manufacturers**

Under a provision enacted in the 1990's (see M.G.L. c. 63 s 38(l)), corporations that perform substantial manufacturing do not use the standard 3-factor apportionment formula. Following a phase-in period that ended in the 2000 tax year, manufacturing corporations are required to apportion their income based only on the sales factor. Unlike other manufacturing tests (which effect local property taxation, sales & use tax benefits and convey eligibility for investment tax credit if the manufacturing is done in Massachusetts) this "section 38 manufacturing" provision applies even if the taxpayer's manufacturing activity is not done within the commonwealth. Use of the single sales factor is not optional - if a corporation's activities qualify it, the corporation uses the single sales factor.

Manufacturing is the process of substantially transforming raw or finished materials by hand or

machinery, through human skill and knowledge, into a product possessing a new name, nature and adapted to a new use. Whether or not a process qualifies as manufacturing depends on the facts of each case, but chemical changes are more likely to qualify than physical changes and manufacturing ordinarily involves the production of products in standardized sizes and qualities and in multiple quantities. A process that does not produce a finished product, but constitutes an essential and integral part of a total manufacturing process may constitute manufacturing.

Further guidance, including examples, can be found at [830 CMR 58.2.1](#)

The requirement to apportion as a “section 38 manufacturer” applies where the taxpayer is engaged in substantial manufacturing. Substantial for this purpose is generally determined in the context of a taxpayer’s entire business, thus while a bakery selling items for off-premises consumption may be a manufacturer, a supermarket chain does not become a manufacturer by adding a comparatively small bakery operation. See [Fernandes Supermarkets v. State Tax Commission 371 Mass 381 \(1976\)](#). The numerical tests imposed in determining whether or not a corporation’s manufacturing activities are substantial are essentially those used to determine manufacturing classification under Chapter 58 except that for apportionment purposes, the tests include property, payroll and receipts from activity performed outside of Massachusetts (the tests can be found at [830 CMR 63.38.1 \(10\)](#)).

- 1) **General.** A corporation is a section 38 manufacturer for any taxable year if (i) it is engaged in manufacturing during the taxable year and (ii) its manufacturing activity during the taxable year is substantial. A corporation that is so engaged in manufacturing and whose manufacturing activities are substantial is a section 38 manufacturer for the taxable year regardless of whether, or to what extent, it conducts its manufacturing activities in Massachusetts. The principles set forth in 830 CMR 58.2.1(6)(b) apply for purposes of determining whether a process constitutes manufacturing.
- 2) **Substantial Manufacturing.** A corporation's manufacturing activity is substantial for any taxable year if the corporation meets any of the following tests:
  - a) The corporation derives twenty-five percent or more of its receipts for the taxable year from the sale of manufactured goods that the corporation manufactures;
  - b) The corporation pays twenty-five percent or more of its payroll for the taxable year to employees working in manufacturing operations and derives fifteen percent or more of its receipts for the taxable year from the sale of manufactured goods that the corporation manufactures;
  - c) The corporation uses twenty-five percent or more of its tangible property in manufacturing during the taxable year and derives fifteen percent or more of its receipts for the taxable year from the sale of manufactured goods that the corporation manufactures;
  - d) The corporation uses thirty-five percent or more of its tangible property in manufacturing during the taxable year.
- 3) **Coordination with 830 CMR 58.2.1.** For purposes of 830 CMR 63.38.1(10)b.2, above, the following rules shall apply:
  - a) For any taxable year, the percentage of receipts derived from a corporation’s sale of goods that it manufactures shall be equal to the gross receipts fraction determined for that taxable year under 830 CMR 58.2.1(6)(e)1., except that gross receipts attributable to business activities (including manufacturing activities) performed outside Massachusetts shall be taken into account in the fraction.

- b) For any taxable year, the percentage of payroll working in manufacturing operations shall be ... under 830 CMR 58.2.1(6)(e)3., except that payroll attributable to business activities (including manufacturing activities) performed outside Massachusetts shall be taken into account in the fraction; and
- c) For any taxable year, the percentage of tangible property used in manufacturing operations shall be ... under 830 CMR 58.2.1(6)(e)2., except that tangible property used in business activities (including manufacturing activities) performed outside Massachusetts shall be taken into account in that fraction.

A series of court decisions have recognized that manufacturing, which includes any activity that is an essential and integral part of the manufacturing process, does not require that the taxpayer itself produce the final product to be sold or even that, in some cases, the commencement of the commercial production of the goods to be sold has begun.

In [Commissioner of Revenue v. Houghton Mifflin Co., 423 Mass.42 \(1996\)](#), the SJC found that the creation of computer disks containing graphics and layout information that were designed to be distributed to third parties who would use them to print and bind new books was itself manufacturing because the disks were an essential and integrated step in the manufacturing process even if Houghton Mifflin did not print the books.

In [The Associated Press v. Commissioner of Revenue, 54 Mass. App. Ct. 606 \(2002\)](#), the Appeals Court affirmed a decision of the ATB rejecting the taxpayer's assertion that because, in the conduct of its business as a wire service, it produced files similar in some ways to those produced by Houghton Mifflin it was also a manufacturer. The transmission or manipulation of knowledge or intelligence does not constitute manufacturing. The court took note of the difference between what happened to the content produced by the AP and the files produced by Houghton Mifflin which were sent to the printer. Each recipient of material from AP chose for itself what stories to use, whether or not and how to edit them and how to present them.

In [The First Years Inc. v. Commissioner of Revenue, Docket # C267626 \(2007\)](#) the Appellate Tax Board found that the taxpayer was engaged in manufacturing (in Massachusetts) for the purposes of M.G.L. c. 63 s. 38C where its only Massachusetts activities centered on design and research of new products and improving existing products, along with marketing. As part of bringing an approved concept to market, the taxpayer created a detailed sketch of a new product, determined the quality and safety tests the new product should be submitted to and then either created a physical model or used CAD machines to create computer models which were used by 3<sup>rd</sup> parties to produce molds that in turn were sent to contract manufacturers. The taxpayer retained ownership of the molds and tooling which were used directly in the manufacturing process and employees of the taxpayer oversaw the production process, including trips to visit the manufacturing site and pulling samples from the production line to run quality assurance tests. The Board found that the taxpayer's design and creation activities to be an integral part of the manufacturing. The Department announced it would follow this analysis in the future in [TIR 08-2](#)

In [Onex Communications Corporation v. Commissioner of Revenue, 457 Mass. 419 \(Mass. 2010\)](#), the taxpayer created a "blueprint" for the production of a computer chip which it released to IBM so that IBM could produce the chips under a contract manufacturing agreement. The SJC found the creation of the blueprint to be an essential and integral step in the manufacturing process. In [TIR 10-19](#), the Department announced the following:

With the decision of the SJC in **Onex**, the Commissioner is now incorporating the analysis and

holding of the SJC in that case in determining whether a company is engaged in manufacturing for purposes of G.L. c. 63, § 42B and, accordingly, for purposes of applying the sales and use tax exemptions in G.L. chs. 64H and 64I. In particular, in cases where, as in **Onex**, a company's activities are essential and integral steps in the overall manufacturing process (*i.e.*, where the activity in question is a practical and necessary step in the production of a finished product for sale) the Commissioner will determine that a company is engaged in manufacturing, whether or not the taxpayer or another entity has yet produced a finished product during the relevant period. Thus, in cases where a company designs and creates a prototype, and where that activity is an essential and integral step in the production of a product for ultimate sale, a company will be deemed to be engaged in manufacturing. As the SJC found in **Onex** and in **Houghton Mifflin**, the Commissioner will treat a company's design and creation of items such as a blueprint or computer disk necessary to the production of a product for ultimate sale as being an integral and necessary step in the manufacturing process.

When auditing a taxpayer that has contracted with 3<sup>rd</sup> parties to perform substantial parts of its manufacturing activities or for whom the apparent manufacturing activity is performed outside of Massachusetts, auditors should take care to investigate whether manufacturing apportionment should apply. Taxpayers engaged in what initially appears to be primarily retail activity may in some cases be producing their own goods through contract manufacturers. In such cases it may be a matter for further review. In addition, where the taxpayer's business does involve the sale of tangible property produced either by a contract manufacturer or by an affiliate to specifications provided by the taxpayer (or an affiliate), the auditor should be aware of the possibility that the price paid to the contract manufacturer or affiliate may contain an embedded royalty (e.g. the contract manufacturer's costs include a per-unit royalty paid to the taxpayer's affiliate which the contractor recovers in the price paid by the taxpayer for the resulting product). The sales factor is still computed as described above, and includes receipts from non-manufacturing activities.

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#### **9.4.7 Apportionment of Income for Mutual Fund Service Corporations**

Another special provision enacted in the 1990s (see [M.G.L. c. 63 § 38\(m\)](#)), directs that corporations deriving more than 50% of their gross income from the provision of services to regulated investment companies and employee benefit plans must use a very different apportionment methodology for the income from such services. Rather than apportioning the entire net income using factors derived from all the activities of the business, a Mutual Fund Service Corporation segregates its income into two categories and apportions these two categories separately. The apportioned amounts are combined at the end of the process (a blended apportionment percentage is used for the non-income measure).

The special provisions apply only to those corporations meeting the statutory definition at M.G.L. c. 63 § 38(m)(1):

"Mutual fund service corporation", any corporation doing business in the commonwealth which derives more than fifty percent of its gross income from the provision directly or indirectly of management, distribution or administration services to or on behalf of a regulated investment company and from trustees, sponsors and participants of employee benefit plans which have accounts in a regulated investment company.

The statute also defines administrative services, distribution services and management services

and clarifies that Regulated Investment Company (“RIC”) has the meaning set forth in IRC § 851. Note that the services may be provided as a subcontractor (e.g., to an affiliate which has a contract to provide the same services to a RIC), but they must be provided to a RIC or to participants in employee benefit plans that have accounts in a RIC. A corporation that does not meet the 50% threshold test does not qualify for mutual fund service corporation apportionment.

A corporation that does meet this threshold apportions its taxable net income as follows:

M.G.L. c. 63 § 38(m)(2): Notwithstanding any other provision of the General Laws, any mutual fund service corporation having income from mutual fund sales to one or more regulated investment companies with shareholders domiciled within and without this commonwealth shall apportion such income pursuant to the provisions of subsection (c). Furthermore, any such

mutual fund service corporation whose employment level in the current taxable year is equal to or greater than its jobs commitment level for such taxable year and who satisfies the requirements of paragraphs (3) and (4), or any such mutual fund service corporation for which the jobs commitment level requirement no longer applies shall apportion such income by multiplying it by one hundred percent of the sales factor, subject to the provisions of clause (i).

M.G.L. c. 63 § 38(f) ... Notwithstanding the foregoing, mutual fund sales as defined in subsection (m), other than the sale of tangible personal property, shall be assigned to the commonwealth to the extent that shareholders of the regulated investment company are domiciled in the commonwealth as follows:

(a) by multiplying the taxpayer's total dollar amount of sales of such services on behalf of each regulated investment company by a fraction, the numerator of which shall be the average of the number of shares owned by the regulated investment company's shareholders domiciled in the commonwealth at the beginning of and at the end of the regulated investment company's taxable year that ends with or within the taxpayer's taxable year and the denominator of which shall be the average of the number of shares owned by the regulated investment company shareholders everywhere at the beginning of and at the end of the regulated investment company's taxable year that ends with or within the taxpayer's taxable year.

(b) A separate computation shall be made to determine the sale for each regulated investment company, the sum of which shall equal the total sales assigned to the commonwealth.

The commissioner shall promulgate regulations to implement this paragraph.

The reference to the jobs commitment level in § 38(m)(2) is effectively inoperative. The statute, originally enacted in 1996, included provisions requiring mutual fund service corporations to increase their employment levels in the commonwealth through the 2003 taxable year. The regulation clarifies that all corporations are deemed to meet this requirement for tax years after 2003.

A mutual fund service corporation determines how much of its taxable net income from mutual fund sales is apportioned to Massachusetts according to [830 CMR 63.38.7 Apportionment of Income of Mutual Fund Service Corporations](#). The following steps are taken in the order listed:

- (1) The corporation must separate its gross income into two categories: (i) mutual fund sales and (ii) non-mutual fund sales. If the gross income from mutual fund sales is not more than 50% of the total, STOP (the taxpayer does not qualify as a mutual fund service corporation). For years beginning January 1, 2014 and after, if the corporation is required to apportion its income, it will complete steps 4 through 6 below in determining what portion of the mutual fund receipts should be attributed to Massachusetts in a standard 3-factor apportionment calculation.

- (2) The mutual fund service corporation must also separate its allowable deductions into categories: (i) deductions directly traceable to mutual fund sales, (ii) deductions directly traceable to non-mutual fund sales, and (iii) other allowable deductions. The category of other allowable deductions consists of deductions not directly traceable to either type of sale.
- (3) Taxable net income from mutual fund sales equals gross income derived from mutual fund sales less: (i) any deductions directly traceable to its mutual fund sales and (ii) a portion of other allowable deductions (those not directly traceable to either category of gross income.) The portion of “other allowable deductions” to be subtracted from mutual fund sales gross income is determined by the ratio of mutual fund sales gross income to the total gross income of the corporation.
- (4) Mutual fund sales are determined separately for each RIC from which the Mutual Fund Service Corporation receives fees. Note that while the statute and the regulation generally define the term “mutual fund sales” as “net income” in paragraph 3(d) of the regulation, the context of the apportionment calculations from this point on, and the example provided in the regulation in paragraph (4), present it as a gross income amount from this point forward.
- (5) Mutual fund sales for each RIC are then multiplied by a fraction, the numerator of which is the average number of shares owned by the RIC's shareholders domiciled in Massachusetts at the beginning and end of the RIC's taxable year that ends with or within the mutual fund service corporation's taxable year, and the denominator of which is the average number of shares owned by all of the RIC's shareholders for the same period.
- (6) The resulting amounts for each RIC are then added together. The sum is the amount of mutual fund sales assigned to Massachusetts.
- (7) The sales factor is a fraction, the numerator of which is the amount of mutual fund sales assigned to Massachusetts and the denominator of which is the mutual fund service corporation's total amount of mutual fund sales.
- (8) A mutual fund service corporation will multiply this sales factor by the taxable net income from mutual fund sales (determined under step (3) above) to calculate the portion of such income taxable in the commonwealth.

After determining its apportioned income under the above procedure, the Mutual Fund Service Corporation must add to this income its apportioned taxable net income from other sources. The amount of this latter income to be apportioned is the gross income from sources other than mutual fund sales, less the appropriate directly-traceable deductions and a proportionate share of the other allowable deductions (both as identified in step (2) above). The apportionment percentage applicable to net income from other sources is determined under the standard 3-factor formula calculated using the property, payroll and sales that relate to that income.

For purposes of the calculation of the number of RIC shares owned by persons domiciled in Massachusetts (step (5) above), mutual fund sales are assigned based on the domicile of the RIC's shareholders of record. The domicile of a shareholder of record is generally the shareholder's mailing address on the records of the RIC. Notwithstanding this general rule:

(i) if a shareholder of record is an affiliated RIC, then for shares held by such affiliated RIC, the mailing addresses of the shareholders of record of the affiliated RIC shall be presumed to be the domicile of the shareholder of record, determined proportionately with respect to the shares of the affiliated RIC held by each such shareholder of the affiliated RIC.

(ii) if a shareholder of record is a company which holds the shares of the RIC as depositor for the benefit of a separate account, then for all shares held in such separate account the mailing address of such company shall be presumed to be the domicile of the shareholder of record. However, if either the RIC or mutual fund service corporation has actual knowledge that the company's mailing address is different than the company's principal place of business, then the presumption does not apply and the address of the company's principal place of business shall be considered the domicile of the shareholder of record.

Whether a taxpayer allocates expenses or gross receipts from MF to NMF has no bearing on the income measure of a unitary tax return. It only impacts the calculation of the non-income measure.

Sample IDR's for Mutual Fund Service Corporation apportionment found in the [Appendix](#).  
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#### **9.4.8 Special Apportionment Rules**

##### **Office Opened to Reduce the Tax**

In addition to the general authority to disregard the tax consequences of "Sham" transactions when determining tax liability (see M.G.L. c. 62C § 3A), a longstanding provision in the apportionment rules should be kept in mind in any apportionment review:

M.G.L. c. 63 § 38(h) - "If a corporation maintains an office, warehouse or other place of business in a state other than this commonwealth for the purpose of reducing its tax under this chapter, the commissioner shall, in determining the amount of taxable net income apportionable to this commonwealth, adjust any factor to properly reflect the amount which the factor ought reasonably to assign to this commonwealth."

##### **Industry-Specific Apportionment Provisions**

M.G.L. c. 63, § 38(j) authorizes the Commissioner of Revenue to adopt different apportionment provisions for different industries when it is determined that the general apportionment provisions in section 38 are not reasonably adapted to approximate net income derived from business activity carried on in this Commonwealth. Although these regulations provide alternative apportionment methodology, they nonetheless usually apply alternative calculations of property, payroll and sales. The factors that are not modified by the industry-specific regulations are to be calculated under the generally applicable apportionment rules.

Each of the special apportionment regulations includes a description of the type of business to which it applies. Use of an industry-specific formula is not optional if the taxpayer falls into the industry group covered by the special regulation. Whether the taxpayer does fall into one of these categories is a question of fact. The regulations currently in effect are described below:

**[830 CMR 63.38.2 - Apportionment of Income of Airline Corporations](#)**. The industry regulation provides alternative rules for determining property and payroll in Massachusetts, using the percentage of the airline's departures in Massachusetts and the value of the planes to attribute aircraft ready for flight and the payroll of the flight crews. Non-flight property and payroll are attributed based on the general rules applicable to all corporations. The assignment of flight revenues to the numerator of the sales factor for taxable years beginning on or January 1, 2014 is calculated under the provisions of 830 CMR 63.38.1(9)(d)4.b.iii. and relies on the ratio of departures in Massachusetts to the total departures everywhere weighted by the value of aircraft used. Prior to the 2014 statutory change, a somewhat similar rule directly applied under 830

CMR 63.38.2.

**830 CMR 63.38.3 - Apportionment of Income of Motor Carriers.** The industry regulation provides alternative rules for determining property and payroll in Massachusetts, using the ratio of miles traveled in Massachusetts to attribute the value of mobile property and the payroll of the operating personnel. The assignment of revenues from carrying passengers or freight to the numerator of the sales factor for taxable years beginning on or after January 1, 2014 is calculated under the provisions of 830 CMR 63.38.1(9)(d)4.b.iii. and relies on the ratio of pick-ups and deliveries in Massachusetts to the total of all pick-ups and deliveries. Prior to the 2014 statutory change, those sales were attributed based on miles traveled in Massachusetts divided by all miles traveled.

**830 CMR 63.38.4 - Apportionment of Income of Courier and Package Delivery Services.** The industry regulation is somewhat of a hybrid of the Airline and Motor Carrier regulations, attributing property and payroll from flight operations based on departures and the property and payroll from non-flight mobile operations (delivery trucks) using the Motor Carrier rules. The assignment of revenues from carrying passengers or freight to the numerator of the sales factor for taxable years beginning on or after January 1, 2014 is also calculated under the provisions of 830 CMR 63.38.1(9)(d)4.b.iii. and relies on the ratio of pick-ups and deliveries in Massachusetts to the total of all pick-ups and deliveries. Prior to the 2014 statutory change, those sales were attributed based on miles traveled in Massachusetts divided by all miles traveled.

**830 CMR 63.38.8 - Apportionment of Income of Pipeline Companies.** The industry-specific regulation directs that the Pipeline company attribute sales to Massachusetts in proportion to the number of “traffic units” that are in Massachusetts. “Traffic units” are defined as the movement of a barrel of oil, a barrel of gasoline or a thousand feet of natural or casing head gas a distance of 1 mile.

**830 CMR 63.38.10 - Apportionment of Income of Electric Industry.** The industry-specific regulation provides sourcing rules for retail sales of electricity (to the location where the electricity is ultimately delivered), sales of wholesale electricity (to the location of the generator if the taxpayer operates that facility and based on market considerations otherwise), sales of distribution services (to the location where the electricity is delivered) and sales of transmission services (based on miles of transmission lines in Massachusetts divided by miles everywhere). A special rule excludes from both the numerator and the denominator of the sales factor any receipts assignable under these methods to a state in which the corporation is not taxable (“throwout rule”).

**830 CMR 63.38.11 - Apportionment of Telecommunications Industry.** The industry specific regulation provides that the property factor is computed excluding the value of “outer jurisdictional property” such as satellites and undersea cables and that the numerator of the sales factor includes receipts for services where the call either originates and terminates in this state or if the service address is in this state and the call either originates or terminates in Massachusetts. In recognition of the variety of ways in which telecommunications services are now sold, there are additional special rules for mobile, pre-paid, private, wholesale and ancillary services and for bundled transaction.

#### **Alternative Apportionment**

Apportionment is intended to reasonably approximate the net income derived from business carried on in the Commonwealth by a taxpayer operating a multi-state business. [M.G.L. c. 63 § 42](#) and [830 CMR 63.42.1](#) provide taxpayers who believe that the general formula does not

reasonably approximate this amount, the opportunity to propose a calculation that does. The taxpayer must file its return using the statutory formula and also file with the commissioner, Form AA-1, setting forth its alternative calculation.

Approval of an alternative apportionment application is discretionary with the Commissioner. The applicant must show by clear and cogent evidence that the income attributed to Massachusetts using the statutory apportionment method is in fact out of all proportion to the business transacted in Massachusetts, or that the statutory apportionment has led to a grossly distorted result.

A taxpayer may not pursue alternative apportionment through an audit. An application must be made to the Department on an original (and timely filed) return. If the application is granted and the return is subsequently selected for audit, the auditor must review the methodology proposed by the taxpayer and accepted by the Department in order to adjust the audit procedure to ensure that the taxpayer is conforming to the agreed-upon alternate apportionment method.

### **Corporate Partners**

A corporation with an interest in a partnership must include its distributive share of the partnership income when calculating its own taxable net income. A foreign corporation that is not otherwise taxable in Massachusetts is taxable in Massachusetts if it is a general partner in a partnership conducting business activities that, if conducted directly by the corporation, would make the corporation taxable in Massachusetts. Where the foreign corporation is a limited partner in the same partnership that foreign corporation is also taxable in Massachusetts, but if the business activities of partnership and the corporation are unrelated, the corporation is taxable in Massachusetts only with respect to the partnership activities. Similar rules apply for determining whether a corporation is taxable in another state because of the business activities of a partnership. See [830 CMR 63.38.1 \(12\)](#).

If the partnership and the corporation are engaged in related business activities, then the corporation's pro rata share of partnership property, payroll and sales are included in the corporation's apportionment factors. In order to avoid duplication, factors that represent transactions between the corporation and the partnership are adjusted. Each of these adjustments applies to both amounts in the numerator and amounts in the denominator of any factor:

- ✓ Where the corporation rents property to the partnership, it must include the full original cost of the property in its property factor, and the value as rented property in the hands of the partnership is ignored.
- ✓ Where the partnership rents property to the corporation, the corporation includes its pro-rata share of original cost to the partnership, plus eight times the annual rent multiplied by its pro rata share of the partnership's factors = 1. If the corporation has a 20% interest in the partnership, it will include 80% (100%-20% = 80%) of the rental value in its property factor.
- ✓ In determining the payroll factor, the corporation includes its pro-rata share of the partnership's payroll.
- ✓ In determining its sales factor, the corporation eliminates sales to the partnership to the extent of its pro-rata share in the partnership (if the corporation owns 20% of the partnership, then 20% of its sales to the partnership are eliminated). Sales by the partnership to the corporation are includible in the corporation's sales factor only to the extent they exceed its pro-rata share of the partnership's sales.

The regulation includes several examples.

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#### **9.4.9 Corporate Apportionment - Audit Review Checklist**

Both the income and the non-income measures of excise are affected by apportionment calculations. The following steps should be taken by the auditor as a starting point in planning the apportionment review. At all times the auditor is expected to bear in mind the audit risk (in dollar terms) of an issue, to focus on issues that are likely to result in changes that have significant tax effect, and to avoid spending time on insignificant issues:

- ✓ Review and confirm the taxpayer's eligibility for apportionment. Nexus and apportionment eligibility are determined at the level of each individual corporation. Information gathered in the income and balance sheet verification sections of the audit should be considered here and throughout the apportionment review. If the taxpayer, on a separate company basis, has a bona fide office in another state, the Schedule A should clearly confirm this. The nature of the taxpayer's business may also make this clear-cut (e.g., the provision of landscaping services to customers within 25 miles of Fitchburg).
- ✓ Review the taxpayer's financial statements to verify that the taxpayer has used the correct apportionment formula (standard, manufacturing, mutual fund service, etc.). Note that different members of a controlled group may be required to use different formulas. If there is a question of whether or not the taxpayer qualifies to use a particular method, the taxpayer must document the reasons for their choice (e.g., provide figures showing that manufacturing accounts for 25% or more of their receipts).
- ✓ Review the taxpayer's apportionment work papers and verify the calculation of both the numerator and the denominator of each factor based on the figures provided. Determine if the taxpayer has included factors from a partnership or other pass-through entity in the apportionment calculations (and if it should). If the apportionment workpapers provided do not include partnership factors, and there is evidence that they should, and the denominators shown on the return exceed those in the workpapers, this should be taken into account in prioritizing issues to be addressed. Where the taxpayer is likely to be able to prove the original figures with additional documentation, audit time may be better allocated to other issues.

#### **Property Factor Issues**

- ✓ Compare the fixed asset values used to the trial balance and the depreciation detail. Verify that the taxpayer has valued all assets at cost. If there is a wide swing between the beginning and the ending figures for assets at cost in any tax year, determine the reason and consider if the average should be computed using monthly figures (e.g. if a sale of most Massachusetts operations occurs 3 weeks prior to the end of the fiscal year, the property factor may be understated by using only the beginning and ending values).
- ✓ Compare the trial balance and Schedule A figures for inventory to those used in the apportionment calculations. Verify that the taxpayer has correctly accounted for inventory, reversing any reserves (property is valued at cost) and accounting for all inventory owned.
- ✓ Identify property in transit (most commonly inventory) and verify that it has been included in the apportionment based on its destination.
- ✓ If the amount is potentially significant, verify that mobile property has been allocated on a reasonable and consistent basis.

- ✓ Verify that property owned but rented to others is included in the property factor and that receipts from these transactions are included in the sales factor.
- ✓ Identify any rental expenses (including automobile leases, equipment rentals, taxes or insurance paid as additional rent, etc.) and verify that the figures used in the apportionment percentage are correct.
- ✓ Identify any sub rentals. Any rental expense should be offset by related sublease income in determining the rented property component of the property factor (note that the sub-rentals will also be relevant in calculating the sales factor). These offsets must be done on a property by property basis and the portion of the rental expense offset for apportionment purposes may not exceed the portion of any property actually subleased (even if the taxpayer is being paid more for the sub rental than their obligations on the lease).
- ✓ If the return under audit is for a period of less than 12 months, verify that the rental expenses have been annualized.
- ✓ Identify property used at little or no cost and verify that it was included in the apportionment calculations. This is commonly seen when one affiliate "hosts" other members of the group in a combined office.
- ✓ For Financial Institutions only – determine how the taxpayer determines “substantive contacts” for various classes of loans (business, personal, etc.) and determine whether or not or how to test the allocation.
- ✓ For Financial Institutions only – compare the property fraction for loans with the fraction for receipts. Determine the reason for any discrepancies.
- ✓ For Financial Institutions only – compare the total value of loans on the taxpayer’s workpapers to the gross value of loans on its trial balance and/or financial statements. Identify any discrepancies in valuation that may be tied to reserves.

**Computation of Numerator**-To determine that the numerator has been properly computed:

1. Review the taxpayer's apportionment factor work papers showing the factor distribution by the taxpayer and will provide insight into the taxpayer's method for factor assignment.
2. Verify that all property has been attributed to some location.
3. Review the taxpayer's Chart of Accounts since the account codes typically identify the office and branch locations. Knowledge of these codes can be important in disclosing anomalies such as loans being assigned to a location for factor purposes different from the location where they are being booked.
4. Review branch statements which provide information as to activities within Massachusetts and activities with other branches that may have an impact on the factor.

**Computation of Denominator**-To determine that the denominator has been properly computed:

1. Verify that total loans have been included at the outstanding amount, excluding such items as reserves against loans, and loans charged off for federal income tax purposes.
2. Verify that total credit card receivables have been included as the outstanding balance amount, excluding bad debt reserves.
3. Verify that total real property owned has been included at cost.
4. Verify that total tangible property rented has been included and capitalized at eight times the rental value. Note: Leasehold improvements should be treated as rents.

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### **Payroll Factor Issues**

- ✓ Determine the method used by the taxpayer to calculate wage apportionment (wages paid or accrued). If accrued wages are used, verify that the taxpayer has included all employee compensation (not just base payroll but bonuses, etc.) in the calculations and that they have correctly divided the Massachusetts and non-Massachusetts amounts.
- ✓ Determine the method used by the taxpayer to determine the state to which the employee's wages should be attributed.
- ✓ If wage apportionment has been done on a wages paid basis, verify that the amounts shown for Massachusetts wages match the figures used on the Department of Employment Securities Form and that wages everywhere for the calendar year correspond to the figures on IRS Form 940 (or the sum of the quarterly figures from the IRS Form 941).
- ✓ If the taxpayer has used one corporation as common paymaster for several businesses, verify that wages have been correctly assigned to each corporation for apportionment.
- ✓ If the taxpayer has used leased employees, verify that they have included amounts paid for the services of those individuals in the calculations.

### **Sales Factor Issues**

- ✓ Verify that the taxpayer has properly segregated sales of tangibles from other types of receipts.
- ✓ Verify that the taxpayer has properly quantified revenues from the sale of tangible property and the sales of services. This may also require the auditor to select specific transactions from records used to produce sales by state and to verify that they have been properly categorized. If the taxpayer is reducing receipts to reflect adjustments to invoice prices (e.g. discounts taken at the time of payment), verify that they are being attributed to the proper transactions.
- ✓ For sales of tangible property, verify that the taxpayer is using the destination of the goods in preparing sales by state schedules. Possible testing methods include selecting a customer with more than one shipping address and verifying through examination of some specific transactions that goods shipped to each address ended up assigned to the correct state in the sales by state figures.
- ✓ For sales of tangible property, verify that the taxpayer has applied the throwback provision properly. Has the taxpayer considered throwback to all states in which they do not file returns, and if not why? Has the taxpayer determined which individual "sold" property and to which sales office is each employee assigned to for throwback purposes, and are these determinations reasonable (note that information from the opening conference may play a large role in this evaluation). Are sales to affiliates treated differently for throwback purposes (and should they be based on the facts?).
- ✓ For sales other than sales of tangible property in years prior to 2014, review the taxpayer's methodology for dividing the sales into separate items of income and determining the costs of those revenues in each state for apportionment. Possible testing methods include examining selected service transactions from the sales register and determining the costs of performance and where the performance activities were conducted in sourcing these sales.
- ✓ For sales other than sales of tangible property in years 2014 and after, review the taxpayer's methodology for determining the state in which the service is received. For each category of service, consider testing selected transactions to (a) verify that the taxpayer has used the primary rule if possible and (b) that the data used by the taxpayer in attributing services is accurate.
- ✓ Verify that the taxpayer has included all relevant receipts in its apportionment calculations, including items such as management fees, services fees, sub-rentals, and fixed asset sales that

may have been uncovered in other portions of the audit.

✓ For Financial Institutions only –

1. Obtain taxpayers work papers used to develop the receipts factor. Determine how the work papers were developed. What was the source of information used to calculate the receipts factor?
2. Reconcile total sales per Federal 1120 to MA Schedule E.
3. Insure that the taxpayer includes net gains (not gross receipts) on asset sales in the receipts factor.
4. Net gains means netting gains and losses from asset sales. If the net of gains and results in a negative amount, the amount for the factor is zero.
5. If the taxpayer has several branches, determine how the taxpayer has accumulated receipts factor information for the numerator. For example, are loans originated at each branch booked to that branch under normal accounting procedures.
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## 9.5 Corporate Nexus

Before a state may impose a tax there must be a sufficient connection between the state and the person it proposes to tax, generally referred to as a “nexus.” The reason for this is to abide by the principles outlined in the Commerce Clause and the Due Process Clause of the US Constitution.

Corporate nexus in the context of Chapter 63 is the connection between the person

Massachusetts seeks to tax and the legal authority Massachusetts has to impose such tax.

Corporate nexus is generally addressed for business corporations at G.L. c. 63, § 39 and 830 CMR 63.39.1. It is also addressed specifically for financial institutions under M.G.L. c. 63 § 1 (which includes the definition shown below):

“Engaged in business in the commonwealth”, (a) having a business location in the commonwealth; (b) having employees, representatives or independent contractors conducting business activities on its behalf in the commonwealth; (c) maintaining, renting or owning any tangible or real property in the commonwealth; (d) regularly performing services in the commonwealth; (e) regularly engaging in transactions with customers in the commonwealth that involve intangible property and result in income flowing to the taxpayer from residents of the commonwealth; (f) regularly receiving interest income from loans secured by tangible personal or real property located in the commonwealth; or (g) regularly soliciting and receiving deposits from customers in the commonwealth. With respect to the activities described in clauses (d) to (g), inclusive, activities shall be presumed, subject to rebuttal, to be conducted on a regular basis within the commonwealth, if any of such activities are conducted with one hundred or more residents of the commonwealth during any taxable year or if the taxpayer has ten million dollars or more of assets attributable to sources within the commonwealth, or has in excess of five hundred thousand dollars in receipts attributable to sources within the commonwealth.

A corporation that maintains an office in Massachusetts will have nexus here for tax purposes. As noted above, the nexus rule for financial institutions focuses on in-state activity such as *regularly* performing services, *regularly* engaging in transactions, *regularly* soliciting business, or otherwise taking advantage of the services provided by a state (e.g. police, fire, medical emergency, court, road maintenance services) to conduct its business and derive income from activities in a state. A

similar basic examination is also required for business corporations under M.G.L. c. 63, § 39. [830 CMR 63.39.1](#) includes a list of activities that will give a business corporation nexus in this state.

A nexus determination can affect Chapter 63 tax liability in several ways including:

- A corporation with nexus to Massachusetts must file a return and pay a tax under Chapter 63. While auditors are not expected to expend a large amount of time on nexus issues where the result is an assessment of the minimum excise, in some cases (e.g. a profitable corporation with a substantial portion of its sales in this state) an assessment may be significant. This is especially true where returns have not been filed over several tax periods.
- A corporation already filing in Massachusetts that sells tangible property subject to the throwback sales rule will determine its throwback sales eligibility based on a determination of nexus in the sales destination state. For this purpose, the same rules that give a taxpayer nexus in Massachusetts will generally apply. See [830 CMR 63.38.1\(5\)](#).
- A non-US corporation that has nexus with Massachusetts must not only pay a tax, but must also include its income in a “water’s edge” combined report if it is under common control with another corporation and engaged in a unitary business.
- A corporation that has nexus with Massachusetts and is part of a combined group will have to file as a taxable member of such group. This will require it to pay a non-income measure of excise and may result in a change to the total of the income measures of the members as any sales it may have in Massachusetts will be attributed to it (and not to its affiliates under the *Finnegan* rule – see Chapter 10 Combined Reporting).

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### 9.5.1 Substantial Nexus

In *Quill Corp. v. North Dakota*, 504 US 298 (1992)(a sales/use tax case), the U.S. Supreme Court reviewed earlier decisions to establish what is required for a state (including Massachusetts) to impose a tax on a non-resident without offending the Constitutional requirement that all persons (including corporations) receive due process of law:

The Due Process Clause "requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax," *Miller Bros. Co. v. Maryland*, [347 U.S. 340](#), 344-345 (1954), and that the "income attributed to the State for tax purposes must be rationally related to `values connected with the taxing State.'" *Moorman Mfg. Co. v. Bair*, [437 U.S. 267](#), 273 (1978) (citation omitted).

*Quill*, 504 US at 306. In tracing the history of this issue, the court in *Quill* reviewed *International Shoe Co. v. Washington*, [326 U.S. 310](#) (1945), where it determined that a corporation’s activities were sufficient to give the state jurisdiction to file suit for unemployment taxes due on amounts paid to the corporation’s salesmen where it did not maintain an office there or allow its salesmen to do more than solicit orders for approval outside the state. Some level of “minimum contacts” resulting from the taxpayer’s regular and purposeful business activities was sufficient:

But now that the *capias ad respondendum* has given way to personal service of summons or other form of notice, due process requires only that, in order to subject a defendant to a judgment *in personam*, if he be not present within the territory of the forum, he have certain minimum contacts with it such that the maintenance of the suit does not offend "traditional

notions of fair play and substantial justice."

*International Shoe*, 326 U.S. at 316 (quoting *Milliken v. Meyer*, 311 U.S. 457, 463 (1940)).

But, to the extent that a corporation exercises the privilege of conducting activities within a state, it enjoys the benefits and protection of the laws of that state. The exercise of that privilege may give rise to obligations, and, so far as those obligations arise out of or are connected with the activities within the state, a procedure which requires the corporation to respond to a suit brought to enforce them can, in most instances, hardly be said to be undue.

....

Applying these standards, the activities carried on in behalf of appellant in the State of Washington were neither irregular nor casual. They were systematic and continuous throughout the years in question. They resulted in a large volume of interstate business, in the course of which appellant received the benefits and protection of the laws of the state, including the right to resort to the courts for the enforcement of its rights. The obligation which is here sued upon arose out of those very activities. It is evident that these operations establish sufficient contacts or ties with the state of the forum to make it reasonable and just, according to our traditional conception of fair play and substantial justice, to permit the state to enforce the obligations which appellant has incurred there. Hence, we cannot say that the maintenance of the present suit in the State of Washington involves an unreasonable or undue procedure.

*International Shoe*, 326 U.S. at 319-20. In making nexus determinations, auditors should consider whether the activities of the corporation in the jurisdiction are regular and continuous and also should evaluate how specifically these activities are conducted. In *International Shoe*, the taxpayer employed salesmen living in the state and servicing customers in the state. The taxpayer's activities were regular and purposeful. Although those activities were limited to mere solicitation (and would likely have been covered by PL 86-272 in later years with respect to an income tax (see below)), the taxpayer had sufficient nexus for Washington to sue for collection of the unemployment taxes it had assessed.

A separate and overlapping limitation on state taxation of non-residents applies under the Constitution's Commerce Clause, which applies even if sufficient connection exists to support a state's right to regulate or tax a non-resident.

The two overlapping US constitutional protections (i.e., the Due Process Clause and Commerce Clause) are generally considered together in determining a state's right to tax the income of non-residents. In *Complete Auto Transit v. Brady*, 430 U.S. 274, 97 S Ct. 1076, 51 L. ed. 2d 326 (1977), the Supreme Court articulated a four-part test to determine if a state tax violates the US Constitution:

- 1) The tax is applied to a taxpayer with a substantial nexus with the taxing state;
- 2) The tax is fairly apportioned;
- 3) The tax does not discriminate against interstate commerce (i.e., an out-of-state economic actor); and
- 4) The tax is fairly related to the services provided by the state.

Massachusetts uses formulary apportionment for corporations engaged in multistate business activities, and the rules are applied equally for both Massachusetts and non-Massachusetts companies. Apportionment does not have to perfectly determine the share of income that should be attributable to Massachusetts to be "fair" under this standard, as long as the rules apply equally to domestic and foreign corporations. M.G.L. c. 63, § 42 provides a safety valve if the normal formula produces an absurd result.

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### **9.5.2 Public Law 86-272 and Federal Pre-emption**

Over the course of many years, commercial practices came to dictate that a state taxing a corporation on its in-state business had to tax a corporation with no factories or sales offices (and only sales persons) within its borders. In *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959), the Supreme Court upheld the assessment of taxes on an Iowa corporation but acknowledged a lack of clarity in the state of the law:

That there is a "need for clearing up the tangled underbrush of past cases" with reference to the taxing power of the States is a concomitant to the negative approach resulting from a case-by-case resolution of "the extremely limited restrictions that the Constitution places upon the states. . . ." *Wisconsin v. J. C. Penney Co.*, [311 U.S. 435, 445](#) (1940). Commerce between the States having grown up like Topsy, the Congress meanwhile not having undertaken to regulate taxation of it, and the States having understandably persisted in their efforts to get some return for the substantial benefits they have afforded it, there is little wonder that there has been no end of cases testing out state tax levies. The resulting judicial application of constitutional principles to specific state statutes leaves much room for controversy and confusion and little in the way of precise guides to the States in the exercise of their indispensable power of taxation. This Court alone has handed down some three hundred full-dress [358 U.S. 450, 458] opinions spread through slightly more than that number of our reports. As was said in *Miller Bros. Co. v. Maryland*, [347 U.S. 340, 344](#) (1954), the decisions have been "not always clear . . . consistent or reconcilable. A few have been specifically overruled, while others no longer fully represent the present state of the law." From the quagmire there emerge, however, some firm peaks of decision which remain unquestioned.

Shortly after *Portland Cement*, Congress passed Public Law (PL) 86-272, the Interstate Income Act of 1959. The key provisions of the safe harbor established were:

#### **15 U.S.C. § 381**

##### **(a) Minimum standards**

No State, or political subdivision thereof, shall have power to impose, for any taxable year ending after September 14, 1959, a net income tax on the income derived within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person during such taxable year are either, or both, of the following:

- (1)** the solicitation of orders by such person, or his representative, in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the State; and
- (2)** the solicitation of orders by such person, or his representative, in such State in the name of or for the benefit of a prospective customer of such person, if orders by such customer to such person to enable such customer to fill orders resulting from such solicitation are orders described in paragraph (1).

##### **(b) Domestic corporations; persons domiciled in or residents of a State**

The provisions of subsection (a) of this section shall not apply to the imposition of a net income tax by any State, or political subdivision thereof, with respect to—

- (1)** any corporation which is incorporated under the laws of such State; or

(2) any individual who, under the laws of such State, is domiciled in, or a resident of, such State.

**(c) Sales or solicitation of orders for sales by independent contractors**

For purposes of subsection (a) of this section, a person shall not be considered to have engaged in business activities within a State during any taxable year merely by reason of sales in such State, or the solicitation of orders for sales in such State, of tangible personal property on behalf of such person by one or more independent contractors, or by reason of the maintenance, of an office in such State by one or more independent contractors whose activities on behalf of such person in such State consist solely of making sales, or soliciting orders for sales, or tangible personal property.

**(d) Definitions**

For purposes of this section—

(1) the term “independent contractor” means a commission agent, broker, or other independent contractor who is engaged in selling, or soliciting orders for the sale of, tangible personal property for more than one principal and who holds himself out as such in the regular course of his business activities; and

(2) the term “representative” does not include an independent contractor.

“Net Income tax” is defined in 15 U.S.C. § 383 to include any tax imposed on, or measured by, net income.

The new law gave some protection to taxpayers if they limited their activities in a state to solicitation of orders for tangible property. The limits of solicitation were not defined. In *Wisconsin Department of Revenue v. William Wrigley, Jr., Co.*, 505 U.S. 214 (1992), the Supreme Court held that solicitation included activities beyond merely asking for an order, but limited solicitation to activities that served no independent business function apart from their connection with the soliciting of orders. Those activities not entirely ancillary to requests for purchases (i.e., activities the company would engage in anyway, including repairs, service activity, etc.) exceed solicitation and would allow the state to tax the corporation’s income. Significantly, the court rejected a simple pre-sale/post-sale distinction as unworkable because of the continuing relationship between many manufacturers and their customers (i.e., does the activity relate to the sale that just occurred or to sale you want to make in the future?), but post-sale activities may still bear additional scrutiny. Activities the corporation would perform in any case do not become protected activities because they are assigned to the corporation’s sales force.

The Court considered six activities performed by Wrigley within Wisconsin that the state asserted went beyond the “solicitation of orders”:

- 1) the replacement of stale gum by sales representatives – Wrigley sold through wholesalers but its sales representatives also visited retailers in their assigned territory for promotional purposes. When visiting a retailer, they would check the gum for freshness and replace any gum that was not fresh without charge to the retailer. The Court found this was not a PL 86-272 protected activity because while it may have been good for business, it did not facilitate the requesting of sales.
- 2) the supplying of gum through “agency stock checks” where salesmen would provide additional gum to the retailers from merchandise they carried with them if the retailer did not have enough on hand to fill the display. The Court found that this as also not a protected activity as it was not related to solicitation of orders to be approved outside the state; the salesmen provided the gum from its in-state stock and Wrigley arranged to have the stores billed by its wholesalers.

- 3) the storage of gum, racks, and promotional materials. Wrigley's sales representatives kept these things, mostly in their homes for use when visiting retailers. The Court found that the storage of gum was also not a protected activity where the vast majority of the gum stored was used in non-protected activities.
- 4) the rental of space for storage by one salesman who lacked storage space in his home for the gum, racks, etc. for \$25/month, the cost being reimbursed by Wrigley. The Court found that these rentals were not protected activity because of how the gum was used in Wrigley's business.
- 5) the regional manager's recruitment, training, and evaluation of employees - the Court found that this was a protected activity as it served no purpose apart from its role in facilitating solicitation.
- 6) the regional manager's intervention in credit disputes. – the Court found that this activity was ancillary to solicitation and thus it was a protected activity; the Court found the purpose of having the sales staff perform this activity with was to ingratiate them with the customer.

The Court in *Wrigley* also acknowledged a *de minimis* standard, allowing that Wrigley could receive the benefit of PL 86-272 protection if its unprotected activities (i.e., activities beyond those protected by the statute) were trivial. However, the Court set the bar for what constitutes *de minimis* very low:

Finally, Wrigley argues that the various nonimmune activities, considered singly or together, are *de minimis*. In particular, Wrigley emphasizes that the gum sales through "agency stock checks" accounted for only 0.00007% of Wrigley's annual Wisconsin sales, and in absolute terms amounted to only several hundred dollars a year. We need not decide whether any of the nonimmune activities was *de minimis* in isolation; taken together, they clearly are not. Wrigley's sales representatives exchanged stale gum, as a matter of regular company policy, on a continuing basis, and Wrigley maintained a stock of gum worth several thousand dollars in the State for this purpose as well as for the less frequently pursued (but equally unprotected) purpose of selling gum through "agency stock checks." Although the relative magnitude of these activities was not large compared to Wrigley's other operations in Wisconsin, we have little difficulty concluding that they constituted a nontrivial additional connection with the State. Because Wrigley's business activities within Wisconsin were not limited to those specified in § 381, the prohibition on net-income taxation contained in that provision was inapplicable. While the Wrigley corporation's non-protected activities were not large compared to Wrigley's overall activities in Wisconsin, the Court had little difficulty concluding that Wrigley's activities constituted a nontrivial additional connection with the State and allowed Wisconsin to impose a tax. It is worth noting that the agency stock check gum sales were less than \$1,000 per year, the value of the property stored in Wisconsin was a few thousand dollars at any one time (40% of which was stale gum on the way to a landfill) and the rental expense was a mere \$25 per month. These specific facts emphasize that the Court's *de minimis* test does not utilize a particularly high threshold.

Of additional note is that the application of PL 86-272 does not affect a determination that the taxpayer has Nexus in Massachusetts. The federal pre-emption bars the imposition of a net income tax, nothing more. M.G.L. c. 63 s 39 was amended in 2008 to clarify that the Massachusetts non-income measure (most likely an apportioned share of net worth in cases involving the sale of tangible personal property) and the minimum excise do apply (i.e.,

irrespective of the application of PL 86-272).

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### **9.5.3 Geoffrey (SC and MA), Capital One and Nexus without any Physical Presence**

In *Quill Corp. v. North Dakota*, 504 US 298 (1992), the state of North Dakota attempted to impose a sales/use tax on a mail order business with no physical presence in the state. The Supreme Court had previously ruled, in *National Bellas Hess v. Department of Revenue*, 386 U.S. 753 (1967), that the Commerce Clause prohibited a state from requiring a mail order vendor with no physical presence in the state to collect the sales or use tax from its customers (the many local variations in rates, allowable exemptions and administrative requirements might reasonably be unknown to a business whose only contact with the taxing state were by mail or common carrier, creating a significant disincentive). Evolving social, economic and commercial changes and a series of court decisions over the next 20+ years (including *Complete Auto Transit, Inc. v. Brady*) convinced North Dakota that the physical presence test was obsolete. While the Court in *Quill* declined to overrule *National Bellas Hess*, the decision handed down explicitly overruled any precedent that physical presence was required under the Due Process Clause. The Court's decision placed the physical presence test in the Commerce Clause analysis and limited it to sales and use tax:

Like other bright line tests, the *Bellas Hess* rule appears artificial at its edges: whether or not a State may compel a vendor to collect a sales or use tax may turn on the presence in the taxing State of a small sales force, plant, or office. Cf. *National Geographic Society v. California Bd. of Equalization*, [430 U.S. 551](#) (1977); *Scripto, Inc. v. Carson*, [362 U.S. 207](#) (1960). This artificiality, however, is more than offset by the benefits of a clear rule. Such a rule firmly establishes the boundaries of legitimate state authority to impose a duty to collect sales and use taxes and reduces litigation concerning those taxes.

In *Geoffrey, Inc. v. South Carolina Tax Commission*, 313 S.C. 15, 437 S.E.2d 13 (S.C. 1993), *cert. denied* 114 S. Ct. 550 (1993), the South Carolina supreme court rejected the taxpayer's argument that it had no presence in that state and thus could not be taxed under the Due Process Clause. The taxpayer was an intangible holding company, organized and domiciled in Delaware, which owned the Toys R' Us trademarks and trade names. Geoffrey's revenues were from licensing those trademarks to the retail stores owned by affiliates in various states, including South Carolina, for a royalty measured as a percentage of sales.

The Supreme Court of South Carolina upheld the assessment against Geoffrey, noting first the acknowledgement in *Quill* (above) that the nexus requirement of the Due Process Clause can be satisfied even where the corporation has no physical presence in the taxing state, if the corporation has purposefully directed its activity toward the state's economic forum. It dismissed the taxpayer's contention that Geoffrey had not purposefully directed its activities toward South Carolina, and the supporting argument that when the licensing agreement was signed Toys R' Us had no stores in the state:

In our view, Geoffrey has not been unwillingly brought into contact with South Carolina through the unilateral activity of an independent party. Geoffrey's business is the ownership, licensing and management of trademarks, trade names, and franchises. By electing to license its trademarks and trade names for use by Toys R Us in many states, Geoffrey contemplated and purposefully sought the benefit of economic contact with those states. Geoffrey has been aware

of, consented to, and benefitted from Toys R Us's use of Geoffrey's intangibles in South Carolina. Moreover, Geoffrey had the ability to control its contact with South Carolina by prohibiting the use of its intangibles here as it did with other states. We reject Geoffrey's claim that it was not purposefully directed its activities toward South Carolina's economic forum and hold that by licensing intangibles for use in South Carolina and receiving income in exchange for their use, Geoffrey has the "minimum connection" with this State that is required by due process. *Geoffrey*, 437 S.E.2d at 16.

The South Carolina Supreme court further found that Geoffrey's intangible property was partially in South Carolina. It saw no merit to the taxpayer's contention that, on the facts, the US Constitution required that all of the corporation's intangible property be attributed to Delaware. Considering this, and the trial judge's holding that Geoffrey had a franchise in South Carolina, the court held that the presence of the corporation's intangible property in the state separately gave the state the jurisdiction to tax the income derived from those intangibles. The South Carolina court also rejected Geoffrey's contention that the income apportioned to the state was not rationally related to the benefits conferred. It noted that the source of Geoffrey's income was not the paper agreement but the customers at the various Toys R Us stores, including those in South Carolina:

By providing an orderly society in which Toys R Us conducts business, South Carolina has made it possible for Geoffrey to earn income pursuant to the royalty agreement. . . . That Geoffrey has received protection, benefits, and opportunities from South Carolina is manifested by the fact that it earns income in this state. .... That the tax is rationally related to these protections, benefits, and opportunities is evidenced by the fact that the State seeks to tax only that portion of Geoffrey's income generated with its borders.

*Geoffrey*, 437 S.E.2d at 18.

*Geoffrey* held that nexus can be established by the use of intangible property in the state where the corporation does otherwise have a physical location, property or employees. The conclusion was relevant with respect to Geoffrey-like Delaware Holding Companies, which had been aggressively marketed as tax minimization vehicles for a number of years (Geoffrey paid no state income taxes). Confirmation under *Geoffrey* that the income of similar such licensing entities could be taxed gave states another way to attack such structures. In the aftermath of the *Geoffrey* decision, Massachusetts issued [DD 96-2](#) which, among other things, directed many intangible holding companies to file in the state:

**ISSUE:** Under what circumstances will the in-state ownership and use of intangible property subject a foreign corporation to the corporate excise?

**DIRECTIVE:** A foreign corporation's intangible property used within Massachusetts will subject that corporation to the corporate excise where:

- (1) The intangible property generates, or is otherwise a source of, gross receipts within the state for the corporation, including through a license or franchise; and
- (2) The activity through which the corporation obtains such gross receipts from its intangible property is purposeful (e.g., a contract with an in-state company); and
- (3) The corporation's presence within the state, as indicated by its intangible property and its activities with respect to that property, is more than *de minimis*.

After the South Carolina *Geoffrey* case, a similar case, involving the same taxpayer, Geoffrey, Inc., was tried in other states (along with similar cases involved different taxpayers). The states generally prevailed in these cases. A similar case to the *Geoffrey* case involving the same

taxpayer reached the SJC in Massachusetts in 2009 on an appeal of Massachusetts assessments similar to those made by South Carolina. In [Geoffrey, Inc. v. Commissioner of Revenue](#), 453 Mass. 17 (2009), the SJC determined that Geoffrey had nexus with Massachusetts despite not having physical presence, such that the corporate excise could be assessed under chapter 63, section 39: That said, the thrust of Geoffrey's appeal is that, because Geoffrey had no physical presence in Massachusetts, the imposition of the corporate excise under § 39 violated the Federal commerce clause. We disagree.

As we stated at the outset of this opinion, resolution of the physical presence issue under commerce clause analysis is governed by our decision in *Capital One*, supra. We now conclude that substantial nexus can be established where a taxpayer domiciled in one State carries on business in another State through the licensing of its intangible property that generates income for the taxpayer. In reaching this conclusion, we join other jurisdictions that have considered the physical presence issue in the context of intangible property and have upheld the imposition of income-based tax assessments.

*Geoffrey, Inc.*, 453 Mass. at 23 (footnote omitted).

The *Geoffrey* decision issued by the SJC made reference to [Capitol One v. Commissioner of Revenue](#), 453 Mass. 1 (2009), a companion case to the Massachusetts *Geoffrey* case released the same day. In that second case, Capitol One Bank, a Virginia-chartered credit card bank and Capital One F.S.B. (collectively, “Capital banks”) with no offices or employees in Massachusetts, issued credit cards to customers in this state. Those credit cards evidenced a Capital One logo and, subject to procedures for certain transactions, the Capital banks guaranteed payment to the merchants accepting the cards and bore the risk of cardholder non-payment. If there were collection issues, Capital One might employ collection agencies and Massachusetts attorneys to collect delinquent accounts, which included filing civil actions on behalf of the banks in Massachusetts courts. When necessary, the banks obtained garnishments or liens; if legal proceedings were commenced in Virginia, the resulting judgements were domesticated to Massachusetts. The banks spent \$20 Million over 4 years to increase the number of customers they had in Massachusetts (more than doubling the number during the years at issue - to over 400,000 for Capital One Bank) and received millions of dollars in interest and fee income on those accounts during the years at issue. The SJC upheld the assessment of the Financial Institution Excise tax on both of them:

The Capital banks contend that the board disregarded the reasons stated in *Quill* for upholding a “bright-line” test for tax liability and the benefits of such a clear standard. Contrary to the board’s determination, the Capital banks continue, sales and use taxes do not impose a more significant burden on interstate commerce than income-based taxes such that the two types of taxes should be treated differently under the commerce clause. For these reasons, the Capital banks argue that the FIET should be deemed unconstitutional as inconsistent with the Federal commerce clause. We disagree.

*Capitol One*, 453 Mass. at 8-9.

The language of the Supreme Court’s decision in *Quill* explicitly emphasized, on more than one occasion, a narrow focus on sales and use taxes for the physical presence requirement, and suggested that this requirement was limited to those specific assessment and did not apply to the imposition of other types of State taxes. We will not expand the Court’s reasoning beyond its articulated boundaries, particularly where the Court, itself, has limited its holding to a particular form of taxation.

*Capitol One*, 453 Mass. at 12-13.

[W]e conclude that the constitutionality, under the commerce clause, of the Commonwealth's imposition of the FIET is determined not by Quill's physical presence test, but by the "substantial nexus" test articulated in *Complete Auto*. Accordingly, we turn to the facts of the present case to determine whether Capital One and FSB had a substantial nexus with this Commonwealth during the tax years at issue.

While the concept of "substantial nexus" is more elastic than "physical presence," it plainly means a greater presence, both qualitatively and quantitatively, than the minimum connection between a State and a taxpayer that would satisfy a due process inquiry. See note 4, *supra*. Simply put, the test is "substantial" nexus, not "minimal" nexus. In addition to their consumer lending activities, the Capital banks were soliciting and conducting significant credit card business in the Commonwealth with hundreds of thousands of Massachusetts residents, generating millions of dollars in income for the Capital banks. In essence, the Capital banks were providing valuable financial services to Massachusetts consumers, for which the Capital banks were compensated in the form of interest payments, interchange fees, and finance charges. They could not provide such services in the Commonwealth without using Massachusetts banking and credit facilities. In addition, the Capital banks addressed customer complaints with the assistance of the Massachusetts Attorney General's office, and, when necessary, they used the Massachusetts court system to recover payment for delinquent accounts. Based on the findings of the board, we conclude that Capital banks' activities in Massachusetts established a substantial nexus with the Commonwealth and, therefore, the assessment of the FIET on the Capital banks comported with the Federal commerce clause.

*Capitol One*, 453 Mass. at 15-16.

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#### **9.5.4 Nexus Determinations (830 CMR 63.39.1)**

The Massachusetts Nexus regulation [830 CMR 63.39.1](#) provides additional guidance on what will and what won't create nexus in Massachusetts. 830 CMR 63.39.1(4) lists certain specific activities that will require a foreign corporation to file a return in Massachusetts:

- (4) Activities within the scope of M.G.L. c. 63 § 39. Except as provided below in 830 CMR 63.39.1(5)-(6), a foreign corporation must file a return in Massachusetts and pay the associated excise if any one or more of the following apply:
- (a) The corporation is qualified to do business in Massachusetts under M.G.L. c. 181, §4;
  - (b) The corporation actually does business in Massachusetts, whether or not it has qualified to do so. For purposes of M.G.L. c. 63, §39, "doing business" includes:
    - 1. the buying, selling or procuring of services or property;
    - 2. the execution of contracts;
    - 3. the exercise or enforcement of contract rights;
    - 4. the maintenance of a place of business;
    - 5. the employment of labor;
    - 6. each and every other act, power, right, privilege, or immunity exercised or enjoyed in the Commonwealth as an incident to or by virtue of the powers and privileges acquired through corporate form;
  - (c) The corporation exercises or continues its charter within Massachusetts;

- (d) The corporation owns or uses any part or all of its capital, plant or other property in the Commonwealth in a corporate capacity (as opposed to a strictly fiduciary capacity). Without limitation, a corporation owns or uses property in Massachusetts if:
1. The corporation owns property that is held by another in Massachusetts under a lease, consignment, or other arrangement;
  2. The corporation uses property in Massachusetts that it holds under a lease, license or other arrangement;
  3. The corporation maintains a stock of goods in Massachusetts (see, however, 830 CMR 63.39.1(6)(c), regarding property stored in a public warehouse).

Auditors should be aware that M.G.L. c. 181, which formerly dealt with foreign corporations, was repealed in 2004. Registration requirements for foreign corporations are now in c. 156D, and the auditor may be required to show that a foreign corporation actually was engaged in business in the commonwealth (not just registered to do so) and that its activities were outside the protection of PL 86-272 (see *Commissioner of Revenue v. Kelly-Springfield Tire Company*, 419 Mass 262 (1994)) before asserting that an *income* tax is due. Also, although the reference to the exclusion for property in a public warehouse is in paragraph (6) in the regulation, the basis for this regulatory provision is stated in the statute. This is consistent with the general rule that nexus is asserted to the extent permitted unless a specific statutory exclusion exists.

Auditors will typically begin a nexus investigation with limited information. In an outbound case (does the taxpayer have nexus in some other state, either to establish the right to apportion or to avoid throwback, etc.), the information needed for the evaluation can usually be gained by asking the taxpayer to explain why they think they have nexus in the other state – i.e., what activities in that state give them nexus? Note that these activities must be current activities – a taxpayer who closed their office in a state 2 years ago may no longer have nexus in that state.

In an inbound nexus case (does the taxpayer have nexus in MA), the auditor may have no more than a lead. Most typically these cases will come from either data-matching (e.g. the taxpayer has payroll here) or from a combined report (in which case the auditor will have to make his/her own leads). Existing documents that may suggest a taxpayer has nexus include:

- 1) **Massachusetts Schedule ABIE** – this is a claim of deduction for intangible or factoring expenses. Determine what the underlying economic activity generating the related member payment was. Depending on the nature of the deduction, the recipient may have nexus in Massachusetts. See [DD 96-2](#).
- 2) **IRS Form 5472** – this is filed by taxpayers under foreign ownership to report their dealings with foreign affiliates, and may show the extent of a non-US corporation's activities with its affiliate in the US (not necessarily in Massachusetts). Determine what the underlying economic activity was.
- 3) **IRS Form 1042** – this is filed to report payments to non-US Persons who may not be unrelated. To the extent the payment reported is for the use of property or services in Massachusetts, the non-US Person may have nexus depending on the extent of its activities here.
- 4) **Payroll, Sales/Use or other tax returns filed by business entities can be matched to records of corporations filing in the commonwealth.** A corporation employing labor in the commonwealth or a corporation with sufficient physical presence in this state to require it to collect sales/use tax will have nexus here.

Note: If the business entity paying these taxes has elected to be treated as a disregarded entity for federal (and state income tax purposes), its owner will have filed Massachusetts Schedule DRE with its Massachusetts return – thereby allowing the nexus lead to be eliminated provided the owner has filed.

- 5) **Financial statements filed by or on behalf of the taxpayer that detail the nature of the taxpayer's business and the existence of major divisions and/or subsidiaries.** To the extent these show the income of a non-nexus company, this information may be useful in determining whether or not to pursue the issue further.
- 6) **Information available from prior corporate audits and from other tax type audits, including audits of unrelated taxpayers** (Note to the extent such unrelated taxpayer information is utilized and becomes part of an audit file, such information may need to be redacted in later discovery).
- 7) **Information available from DOR's internal data retrieval system about contacts with Massachusetts.** This includes data from other state agencies including:
  - Secretary of State
  - Department of Labor
  - Department of Highways
  - State Purchasing Department
  - Liquor Enforcement
  - Ports of Entry
  - Parks and Recreation
  - Institutions of Higher Learning
- 8) **After preliminary evaluation, the auditor will decide whether or not to issue a request for further information.** A model nexus questionnaire is attached to this procedure in the [Appendix](#).

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### 9.5.5 Nexus Checklist

In evaluating whether or not a corporation has nexus in Massachusetts or any other jurisdiction, the auditor should review the taxpayer's business model. For example, the auditor should consider how this taxpayer contacts customers and potential customers, what goods or services it provides and what the taxpayer does to generate revenue. The answers to these questions will help determine what other steps should be taken. Not all of the below-listed items listed will apply to each taxpayer.

- ✓ Is the taxpayer registered to do business in the state or have they been registered in the past? If yes, when did they first register and have they consistently been registered to do business? If they ceased to be registered, why did they cease to be registered? In Massachusetts, these records are maintained by the secretary of state.
- ✓ Where is the taxpayer organized and how is it organized (corporation, LLC, LP, etc.) Does the taxpayer own any disregarded entities and, if so, what do they do.
- ✓ Does the taxpayer own an interest in a partnership or similar pass-through entity and, if so, what is the nature of the interest, what does the pass-through entity do and how are the PTE's activities related to those of the taxpayer? Depending on the ownership structure and the relationship of the partnership to the corporation's activities, Massachusetts may

treat the income and activities of a partnership as separate from the corporation's other income. See [830 CMR 63.38.1 \(12\)](#)

- ✓ What affiliates does the taxpayer have that are taxable in the state and what is the relationship between the business activities of two?
- ✓ Does the taxpayer file tax returns of any kind in the state or did they in the past? If yes, what types of taxes (and how much) do or did the taxpayer pay to the state (and for what tax periods). If the taxpayer ceased filing a particular type of return, why did it stop? In Massachusetts, almost all tax returns are filed with the Department of Revenue.
- ✓ Does the taxpayer file with any regulatory authorities in the state (e.g., the Division of Banks or its equivalent) or did they do so in the past. If so, for what periods has it filed? If the taxpayer is no longer filing, why did it stop?
- ✓ Does the taxpayer own or lease any office, warehouse or other business location in the state (including property rented on its behalf by an agent or property subleased to others). If the taxpayer previously had offices in the state, what happened to them?
- ✓ Does the taxpayer own or lease any other tangible property in the state (including displays, samples, inventory, consignment inventory, work in process, tooling, molds, etc.)? If so, what is the value of the property, how does this property relate to the taxpayer's business operations, and how is the location of the property tracked?
- ✓ What are the taxpayer's sales in the state? How many customers are there in the state and how much in dollar terms is the revenue the taxpayer receives from the state. If the sales are of goods and services, who are the customers or other persons that receive the goods or services? How are these goods or services delivered?
- ✓ How does the taxpayer market the goods or services that are delivered to persons in the state? Does the taxpayer display merchandise, advertise in or send sales representatives into the state? How does a customer place an order? Does the taxpayer take back on return unwanted or defective merchandise?
- ✓ Does the taxpayer provide installation, inspection, repair, warranty or other support services to customers in the state? If so, what services are provided and who provides them. Price lists or similar materials may contain additional detail on the taxpayer's services offered that would may not appear in the trial balance.
- ✓ Does the taxpayer have employees living in or working in the state and what do they do? Are these persons full or part-time? To the extent that some of the taxpayer's business activities logically require a physical presence in the state (e.g., conducting training seminars, installation, repairs, etc.) and those activities are not performed by employees, who performs these services? Note that the taxpayer's contracts, manuals, and job descriptions issued to employees or contractors and its records of expense reimbursements may contain information in this area.
- ✓ Does the taxpayer use non-employee representatives or contractors to solicit sales or perform other sales-related or other activities in Massachusetts? If so, who are these representatives, how are they paid, what do they do, and what control does the taxpayer have over their activities?
- ✓ Does the taxpayer use independent dealers, agents, distributors or other persons to sell products or services in the state? If so what activities are performed by the taxpayer or others on its behalf to investigate, select or monitor these persons?
- ✓ Does the taxpayer license software or provide access to digital goods to customers in the

state? If so, how is the software/digital goods purchased, how is it accessed, and is customer support available? If appropriate, review a copy of the standard agreement used by the taxpayer.

- ✓ What trademarks or other intellectual property does the taxpayer own or use in its business? How is this intellectual property used and by whom? Does the taxpayer receive any revenues from licensing the IP?
- ✓ Does the taxpayer (or an affiliate) provide credit to customers and/or consumers and if so, how, where and by whom is creditworthiness investigated or terms determined and credit authorized? Does the taxpayer maintain a security interest in any merchandise sold?

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## 9.6 Net Operating Loss Deductions

Massachusetts allows business corporations to carry forward and deduct a Net Operating Loss (“NOL”) which is the amount by which deductions allowed under M.G.L. c. 63 § 30.4 exceed gross income under section 30.3. See [section 30.5\(b\)](#). If any allowable section 30.4 deduction is reduced by any other M.G.L. c. 63 provision, only the reduced amount is used to compute the NOL. As an example, [830 CMR 63.30.2\(4\)](#) uses deductions disallowed under M.G.L. c. 63, § 38H(b)). An NOL is carried forward and deducted from taxable net income in future years on a “post-apportionment” basis by being multiplied by the corporation’s MA apportionment percentage in the year the loss was incurred. This post-apportionment amount is deducted from post-apportionment income in a future year.

### NOL Audit Issues

- ✓ NOLs may be carried forward but may not be carried back
  - ✓ NOLs sustained in any taxable year beginning on or after January 1, 2010 may be carried forward for not more than 20 years (NOLs sustained in taxable years beginning prior to January 1, 2010 are limited to a 5 year carry over except as provided under the operation of some other statute). Taxpayers claiming a benefit for a pre-2010 NOL must support such a claim.
  - ✓ To apply the 5-year or 20-year limitation, each “taxable year” is counted regardless of the number of days included. A taxpayer required to file returns for taxable years from January 1 - February 15, 2011, February 16 – March 31, 2011 and April 1 – December 31, 2011 will counts as three (3) taxable years, not one.
  - ✓ In the event of a change of ownership as described in IRC § 382(g), there is a limitation to amount of the corporation’s net income in a post-change year which may be offset by an NOL from pre-change years. The limitation amount is the IRC § 382 limitation multiplied by the ratio of Massachusetts taxable net income to Federal taxable net income. (See [830 CMR 63.30.2\(11\)\(b\)](#))
  - ✓ Taxpayers may not carry forward and deduct losses incurred in years when they were not taxable in Massachusetts. (See M.G.L. c. 63 § 30(5)(d))
  - ✓ Capital loss carryovers are not allowed.
  - ✓ NOL deductions are not available to Financial Institutions or pre-2014 Utility Corporations.
-

**Table - NOL Attributes**

Business Type	NOL Allowed? (Y/N)	NOL Carryover? (Y/N)	NOL Sharing? (Y/N)	NOL Limitation? (Y/N)	Special Provisions
Financial Institution	N	N	N	N	NOL Deduction Not Available
Utility Corporation	N	N	N	N	NOL Deduction Not Available
Security Corporation	N	N	N	N	NOL Deduction Not Available
Business Corporation Form 355 (Pre-2009 free-standing)	Y	Y[1][2]	N	Y[3]	[1] NOLs in taxable years beginning prior to 1/1/2010 limited to 5-yr carryover <u>except</u> where otherwise provided by statute [2] Carryforwards incurred in years
Business Corporation Form 355C (Pre-2009 Combined Group Member)	Y	Y[1][2]	N*	Y[3]	[1] NOLs in taxable years beginning prior to 1/1/2010 limited to 5-yr carryover <u>except</u> where otherwise provided by statute [2] Carryforwards incurred in years
Business Corporation Form 355 (free-)	Y	Y[4][2]	N	N	[4] NOLs in taxable years beginning on or after 1/1/2010 carried forward for not more than 20 years
Business Corporation Form 355U (Combined Reporting Group)	Y	Y[4][2]	Y[5]	Y[3]	[4] NOLs in taxable years beginning on or after 1/1/2010 carried forward for not more than 20 years [2] Carryforwards incurred in years when not taxable in MA are not allowed (M.G.L. c. 63 § 30(5)(d)) [5] NOL may only be shared with

\* A business corporation with a Pre-2009 NOL may carry over and deduct the loss against its own income but pre-2009 losses cannot be shared under combined reporting. See 830 CMR 63.32B.2(8)(d).

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### 9.6.1 NOL Audit Review

#### **Verify Loss Carried Forward against Original Return**

Taxpayers seeking a Net Operating Loss deduction should provide an NOL schedule tracing losses claimed through the year in which the deduction was taken. This includes the original NOL amount, amounts deducted in prior years and the NOL balance available for current year use. Each taxable year should be shown separately if there is more than one NOL available. The NOL schedule should become the audit review starting point.

The auditor should compare amounts shown on the taxpayer's NOL schedule as the original loss for each year with what was reported on the original return. The auditor must verify that the corporation claiming the loss actually incurred the loss since Massachusetts NOLs are not transferrable in a reorganization or absorbed in a merger (there are two exceptions – see [LR 95-4](#) which concludes that a statutory merger which qualifies as an F reorganization under IRC §368(a)(1)(F) does not bar the corporation from taking the pre-reorganization net operating loss in a future year, and the transition rule at 830 CMR 63.30.3(4)(a)7 which transfers the tax attributes of a QSUB that was required to file separately in 2008 to its parent since it is no longer required to file a separate return in 2009.)

Auditors should be alert for differences between the return filed by the corporation in the Loss Year (the year when the NOL was incurred) and the loss claimed as deduction on the audited return. Auditors should also be alert for short year returns in the intervening period indicating a merger or change in control which might invoke an IRC § 382 limitation issue.

**For periods beginning prior to January 1, 2009**, the auditor must first determine the post-apportionment loss from the schedule E filed with the return (this must be recomputed if an NOL deduction was taken on that return). Then, if the corporation claiming the loss carryover in the audit year filed a combined return under the previous version of Section 32B for the Loss Year, the auditor must reduce the NOL by any portion of the loss used to offset income of any other members in that year.

**For years beginning after January 1, 2010**, post-apportionment loss is shown as a separate line item on the return (Schedule E (or Schedule U-ST if a combined report was filed)). This may also apply with respect to the 2009 taxable year if (a) the corporation was a taxable member a combined group filing a combined report or (b) the corporation filed a separate form 355 Schedule E and did not claim an NOL deduction on Schedule E, line 20. If such a deduction was taken on Schedule E, the figures on that schedule must be recomputed without the NOL deduction taken to determine if there was an NOL to begin with and its amount.

#### **Verify the amount of any pre-2009 Loss Used within an “Old-Style” Combined Return**

To determine the amount of a pre-2009 loss used within a combined return, the taxpayer must prepare a schedule showing the separately apportioned taxable net incomes of each member of the group for the year in which the loss was incurred. The post-apportionment losses of the members having NOLs are applied on a pro-rata basis against the post-apportionment income of members having positive apportioned taxable net income. If the total of the apportioned incomes and losses for the group's members is greater than zero, all of the apportioned losses have been used. If the total of the apportioned losses exceeds the total of the apportioned incomes, the NOL available for carryover of each member that had one is reduced proportionately. A sample calculation is set forth below.

Member's Name or (Loss)	IncomeApport. Percent	Apportioned Income/(Loss) Utilized	Losses Post-Apport NOL remaining
Member A (100,000)	20%	(20,000) 8,000	(12,000)
Member B (50,000)	10%	(5,000) 2,000	(2,000)
Member C 200,000	5%	10,000 (10,000)	0

Under the pre-2010 NOL statute, the loss was carried forward on a pre-apportionment basis and the pre-apportionment loss available for Member A in the following year would have been (\$60,000). This is potentially significant if the taxpayer deducted a portion of the loss generated on a pre-apportionment basis in a subsequent year (for example, if the year shown above was 2007, Member A would have converted the loss back to a pre-apportionment amount of \$60,000 (\$12,000 divided by 20%). If Member A then deducted \$25,000 of this loss on a pre-apportionment basis in 2008, it would have had only \$35,000 of pre-apportionment loss remaining for 2009. If it subsequently wanted to take a deduction on a post-apportionment basis, the post-apportionment NOL available would have been \$7,000 = \$35,000 x 20% apportionment in the Loss Year).

Two (rare) circumstances require special handling regardless of whether this was a post-2009 loss or not:

- (a) the taxpayer has claimed a deduction under some statutory provision other than M.G.L. c. 63 § 30.4 (the Net Operating Loss is defined with specific reference to those deductions).
- (b) the taxpayer has income that is allocated or separately apportioned and when combined the amounts reflect a post-apportionment "loss". Under MGL c. 63 § 30.5, a NOL occurs only where deductions exceed income.

### **Tracing the NOL**

Once the original loss has been verified it should be traced to the current year. Corporations are required to carry over losses to the earliest succeeding taxable year in which they may be deducted (see the ordering rules at [830 CMR 63.30.2\(7\)](#)). The auditor will create or review a schedule provided by the taxpayer showing the taxable net income and the amount of any NOL deduction taken for each year from the Loss Year through the current year. The NOL amount deducted in each subsequent year is subtracted from the NOL created in the Loss Year. Only amounts not previously deducted are available in the current year.

#### **Example**

- 2012 Corporation M has a NOL of \$5,000 from the 2012 taxable year.
- 2013 Corporation M has taxable net income of \$1,000 and deducts \$1,000 of NOL.
- 2014 Corporation M has a loss in 2014 and generates another \$1,500 NOL.
- 2015 Corporation M has taxable net income of \$9,000 and deducts \$6,500 of NOL.

Per the tracing analysis, this exceeds the total NOL available. Corporation M has 2 NOLs available for 2015 ... \$4,000 remaining from 2012 and \$1,500 from 2014. Its maximum allowable deduction would be \$5,500. The auditor would make an adjustment reducing the available NOL to \$5,500

Corporation M is taking a \$1,000 NOL deduction in the 2013 year. Given the facts presented that deduction must be from the 2012 NOL (losses may only be carried forward), and the remaining NOL is \$4,000. In some cases, it is necessary to go back further beyond the year of the 1<sup>st</sup> NOL shown on the current year schedule to determine if the NOL deducted in an intervening year

(2013 in the example) was from a still earlier period.

Adding the 2009, 2010 & 2011 years to the example produces a different result:

2009 Corporation M has a NOL of \$4,000 from the 2009 taxable year  
2010 Corporation M has taxable net income of \$500 and deducts \$500 of NOL  
2011 Corporation M has taxable net income of \$1,200 and deducts \$1,200 of NOL  
2012 Corporation M has a NOL of \$5,000 from the 2012 taxable year  
2013 Corporation M has taxable net income of \$1,000 and deducts \$1,000 of NOL  
2014 Corporation M has a loss in 2014 and generates another \$1,500 NOL  
2015 Corporation M has taxable net income of \$9,000 and deducts \$6,500 of NOL

This tracing analysis uses the loss from the 2009 tax year first.

- The \$4,000 NOL is reduced by \$500 to reflect the 2010 deduction and by \$1,200 for the 2011 deduction.
- There is \$2,300 of NOL remaining from the 2009 taxable year when the 2013 return is filed (in addition to the \$5,000 originating in the 2012 taxable year).
- The taxpayer's \$1,000 deduction in 2013 is from the 2009 NOL, leaving NOLs of \$1,300 from 2009 tax year and \$5,000 from the 2012 tax year available to carry forward.
- The 2009 NOL expires at the end of the 2014 tax year and is not available in 2015, but the taxpayer does have the \$6,500 claimed on the return (\$5,000 from 2012 and \$1,500 from 2014).

In some cases the loss must be reduced on a pre-apportionment basis by deductions taken on a pre-apportionment basis and then converted to a post-apportionment amount for 2010 (for 2009 if a combined report was filed).

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### **9.6.2 IRC section 382(g)-Limitation on Income Subject to Offset by NOL Carry forward**

Other than as specifically authorized under the combined reporting regulation (830 CMR 63.32B.2), only the corporation which sustained the loss may take a corresponding NOL deduction. Furthermore, where there is an "ownership change" under IRC § 382(g), the amount of income from a "post-change year" that may be offset with an NOL from a "pre-change year" is limited. Note that this rule does not prohibit a corporation from using a "post-change" NOL to offset income not reached by a "pre-change" NOL by virtue of the section 382(g) income limitation.

The auditor should therefore consider the possibility of a section 382(g) ownership change when reviewing an NOL deduction. Frequently this is identified by the taxpayer when preparing the return (a "Loss Corporation" is required to test for this periodically), and there will be a statement in the return acknowledging this. If the return indicates the taxpayer reviewed the issue and determined that there was no ownership change, they should be able to provide the auditor with work papers that support that determination. If there is no evidence the taxpayer reviewed the issue, then the auditor may choose to look for additional information suggesting such an ownership change by:

- ✓ reviewing the taxpayer's financial statements or their website
- ✓ considering questions that may come up in the opening conference

- ✓ noting the presence of a short-year return in a review of the taxpayer’s filing history (especially if it is followed by a 2<sup>nd</sup> short taxable year and return to the previous fiscal year end)
- ✓ looking for substantial increases or decreases in capital or increase in debt
- ✓ discovering the addition of a new member to a pre-existing federal consolidated group

The text of IRC Sec 382(g) (OWNERSHIP CHANGE) should be reviewed to assist in evaluating whether or not a “triggering event” has occurred. The “testing period” (really a look back period) described in section 382(g)(1)(B) is generally 3 years ending on the date of any ownership shift involving a 5% shareholder or an equity structure shift.

**Annual Section 382(b)(1) Limitation**

The general rule for determining the annual section 382(b)(1) limitation defines the amount of post-change income that can be offset based on the value of the corporation immediately before the change and the highest of the adjusted Federal long-term rates in effect for any month in the 3 calendar month period ending with the calendar month in which the change occurs (the rate is determined and published by the IRS and is used as a reference by this and many other provisions).

**Annual Section 382(b)(1) Limitation = Value of the Old Loss Corporation X Long Term Tax-Exempt Rate**

The annual section 382(b)(1) limitation is subject to several modifications under the Code and pertinent U.S. Treasury Regulations. See IRC Sections 382(b)(3), 382(c)(1) and (2), Treasury Regulation 1.382-5(c) and Treasury Regulation 1.382-5(d).

**Adjustment to Federal Limitation for Differences Between MA Taxable Net Income and Federal Taxable Income**

In the event of a change of ownership as described in IRC § 382(g), there is a further limitation in Massachusetts relating to the amount of the corporation’s net income in a post-change year which may be offset by an NOL from pre-change years. The further Massachusetts limitation amount is the federal IRC § 382 limitation amount as calculated multiplied by the ratio of Massachusetts taxable net income to Federal taxable income (See [830 CMR 63.30.2\(11\)\(b\)](#)). Calculation of the Massachusetts Limitation is normally a straight formula computation:

$$\text{Massachusetts Limitation} = \text{Federal Limitation} \times \frac{\text{Massachusetts Taxable Net Income}}{\text{Federal Taxable Income}}$$

For example, where the Federal Limitation amount is \$300,000, the federal taxable income is \$500,000 and the Massachusetts Taxable Net Income (on a pre-apportioned basis) is \$450,000, the Massachusetts Limitation is

$$300,000 \times \frac{\$450,000}{\$500,000} = \$270,000$$

As demonstrated here, the Massachusetts Limitation amount can exceed the Federal Limitation amount when the differences between MA taxable net income and federal taxable income result

in a MA taxable net income amount that is greater than the federal taxable income by virtue of, for example, one or more income add-backs to federal taxable income.

**Note** - this limitation relates only to the amount of IRC § 382 post-change income that can be offset by pre-change losses in Massachusetts. It is separate and apart from the methodology to be employed when prior loss year NOLs are being applied to a future taxable year.

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### 9.6.3 Adjusting NOL Carryovers

Taxpayers seeking a deduction with respect to activity occurring in a prior year are subject to an audit of that deduction when taking it in the current year even though the prior year may not be open to assessment. The auditor is not assessing the prior year but only determining the correct amount of the current year deduction. The taxpayer annual filing requirement artificially separates deductions falling in one taxable year from income received in another. An NOL deduction is available to mitigate this, not to place taxpayers in a better position by allowing them a deduction they cannot be required to prove. This result is derived from federal income tax case law.

In *Commissioner of Internal Revenue v. Van Bergh*, 209 F.2d 23 (2<sup>nd</sup> Cir. 1954), Judge Learned Hand explained that the purpose of federal NOL carryforward/carryback provisions was to “allow a taxpayer some equivalent for the fact that he has not been able to reduce his tax by a loss, because he has had no income in that year against which to credit it; and the only practicable equivalent is a fiction to treat the loss as a deduction from his income in an earlier, or later, year.” *Van Bergh*, 209 F.2d at 25. The “privilege” of NOL carryback and carryforward was not meant to place the taxpayer in a better position than if the carryback or carryforward had not been allowed “[otherwise] the taxpayer will be put in a better position, when the loss occurs in a later, or an earlier, year than when it occurs in the year when it is allowed as a deduction. That obviously cannot have been the intention.” *Id.*

The *Van Bergh* rationale was adopted in Revenue Ruling 56-285 (1956-1 C.B. 134) (“The fact that the statutory period for assessment of income taxes for the year in which the loss was sustained has expired does not preclude the making of such adjustments as may be necessary to correct the net operating loss deduction.”). The Ruling cited *Phoenix Coal Company, Inc. v. Commissioner of Internal Revenue*, 231 F.2d 420 (2<sup>nd</sup> Cir. 1956) which held that the Commissioner may recompute the NOL in an otherwise closed year for “the purpose of correctly determining the tax liability for a year not barred.” *Phoenix Coal*, 231 F.2d at 422. The court in *Phoenix Coal* cited *Van Bergh* as “directly on point” and reaffirmed the rationale employed therein. See also *State Farming Company, Inc. v. Commissioner of Internal Revenue*, 40 T. C. 774 (1963).

As such, an NOL carryover need not be accepted as shown on the return and the taxpayer may be required to prove it was properly calculated. Auditors may question these calculations and the taxpayer's treatment of certain transactions in the same manner they question transactions in the current audit period. Errors in the later period may form the basis of document requests or adjustments in periods generating the NOL carry forward.

The presence of authority to audit a carryover does not mean it must always be done. Unless there is a reason to believe there is a problem with the taxpayer's computation of income or loss in the prior year, the auditor should recognize that reviewing the return of a prior year in addition to auditing the current year can be a significant commitment. Where an issue is found in current

periods that likely applied in prior years from which the NOL derives, an attempt should be made to limit review to that issue. This is not always possible. Even if the auditor accepts every other aspect of the prior year return as correct, the taxpayer is free to raise issues favorable to them for the purpose of offsetting unfavorable adjustments, or even increasing the amount of the NOL (see *Springfield Street Railway Company, v. United States*, 312 F.2d 754 (Ct. Cl. 1963)). Auditors should consider this possibility when evaluating whether to change prior year carryovers. The example below shows a carryover schedule provided by the taxpayer and the general process used in a review when the auditor identifies an issue in the current year that likely affects the NOL deduction claimed in that year.

Corporation Q is being audited for the year ending 12/31/2015. It is not taxable in any other state and for all relevant years 100% of its income is allocable to Massachusetts. During the course of the audit it is discovered that the taxpayer failed to add \$100,000 in interest on "tax exempt" bonds when determining Massachusetts Net Income. The taxpayer claims an NOL of \$175,000 with respect to the 12/31/2012 tax year. Work papers provided tracing the loss showed the taxpayer's return as filed reported a loss of \$300,000 in that year and used \$50,000 of it against income in 12/31/2013 and \$75,000 of it against income in 12/31/2014.

Taxable Year	Taxable Net Inc. Before NOL Per Return	NOL Deduction Per Return	Taxable Net Income after NOL per Return	Ending Available NOL
2010	25,000	n/a	25,000	
2011	75,000	n/a	75,000	
2012	(300,000)	n/a	(300,000)	300,000
2013	50,000	50,000	0	250,000
2014	75,000	75,000	0	175,000

The auditor should determine when the "tax exempt" bonds were acquired and whether or not the interest income was included in the Taxable Net Income figures in any other year. The bonds were found to have been acquired in December of 2009 and the taxpayer verified that the interest income of \$100,000 in each year was adjusted out in calculating federal taxable income as shown on schedule M-1 and was not added back for Massachusetts purposes. The auditor recalculates the loss for 12/31/2012 and the amounts utilized in the following two years to determine the correct amount of NOL available for use in 12/31/2015. The NOL generated in 12/31/2012 would be reduced to \$200,000 reflecting the additional interest income the taxpayer was required to include. The tracing of the loss would look like this:

Taxable Year	Taxable Net Inc. Before NOL Per Return	Revised Taxable Net Income before NOL per Audit	NOL Deduction Per Audit	Taxable Net Income after NOL per Audit	Ending Available NOL
2010	25,000	125,000	n/a	125,000	
2011	75,000	175,000	n/a	175,000	
2012	(300,000)	(200,000)	n/a	(200,000)	200,000
2013	50,000	150,000	150,000	0	50,000
2014	75,000	175,000	50,000	125,000	0

- 1) The NOL utilized in 12/31/2013 would be increased to \$150,000 reflecting the increase in current year income for that year from \$50,000 (as originally filed) to \$150,000 (including the tax exempt interest overlooked by the taxpayer). The regulation (830 CMR 63.30.2(7)(b)) requires that the loss be carried over the earliest year in which it can be used. The NOL remaining available for 12/31/2014 would be \$50,000 (\$200,000 correctly generated less the \$150,000 "used" in 2013).
- 2) The NOL utilized in 12/31/2014 would decrease to \$50,000 - the full amount available when the recalculation is done. If the statute of limitations is still open for this year, an NIA may be issued for the increase in taxable net income. There is no NOL available for use in 2015.
- 3) The auditor will disallow the \$175,000 NOL deduction claimed in 12/31/2015.

Unless the statute is somehow open for assessment (facts and circumstances) the changes made in 2010 and 2011, even if not in dispute, do not result in an assessment of tax. What the tax should have been may be taken into account in computing the amount of any credit carryover from those years to the current period.

A second scenario auditors may see focuses on apportionment:

Corporation P is a manufacturing corporation that is being audited for the 2015 taxable year. The taxpayer performs installations and repairs on machinery it sells to customers throughout New England and apportions its income. Its Massachusetts apportionment percentage in the current year is 10%. In calculating taxable net income it claims a NOL deduction of \$100,000, reducing taxable net income in 2015 to zero. The tracing schedule shows that this was part of a \$200,000 loss from the 2014 tax year. In reviewing the return or workpapers for that year, the auditor finds that Corporation B did not apportion its income in 2014.

The auditor should determine whether or not Corporation P's activities in 2014 should have required it to apportion and if so, under what formula. The taxpayer activities, including installation and repairs at the customer's location were essentially similar with those in the current year. It was a manufacturer.

The auditor should determine the correct Massachusetts apportionment percentage and apply it to determine the correct post apportionment loss. The taxpayer provides workpapers showing that an apportionment percentage of 15% was appropriate for the 2014 taxable year. The

auditor recalculates the Net Operating Loss from the 2014 tax to be \$30,000 (\$200,000 x 15% apportionment). The NOL deduction taken in 2015 is reduced by \$70,000. There is no remaining NOL carryover available for 2016.

Note that in this example, the auditor does not question the calculation of the pre-apportionment loss. Absence some evidence of significant errors in reporting income or deductions, the auditor determined it was not cost effective to look for additional issues.

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#### **9.6.4 Special Rule for Pre-Combination NOL in a Combined Report**

The use of NOL carry forwards by a taxpayer which incurred the loss prior to mandatory combined reporting is subject to a limitation to prevent, among other things, a combined group which includes such member from transferring MA property or payroll to that member to enhance the post-apportionment value of such member's loss. See 830 CMR 63.32B.2(8)(f). This limitation restricts the loss corporation's post-apportioned NOL carry forward by applying the in-state apportionment factors of such corporation that existed at the time that the loss was incurred, with an election allowed for use of the loss to be greater in certain cases where the loss corporation progressively increases its in-state Massachusetts property or payroll apportionment factors subsequent to the time of the loss. This election is intended to permit the NOL carry forward limitation to be less restrictive for a growing company.

#### **Use Limitation on Combined Group Member's Pre-Combination NOL Carry Forwards**

The limitation of a taxable combined group member's use of its pre-combination NOL carry forwards where such member's losses were incurred when it was subject to a different apportionment methodology than its current tax year is explained in detail in [DD 10-5 \(item IV\)](#). A more detailed review of this is included in the combined reporting section of this manual.

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#### **9.6.5 NOL Deduction Checklist**

The following steps should be taken as a starting point in verifying carry forwards (auditors are required to follow-up as appropriate):

- ✓ Review taxpayer's workpapers tracing NOL carry-forwards
- ✓ Verify that amounts shown on the workpapers equal to the amounts shown on the returns
- ✓ Investigate abnormal results (e.g. MA apportionment drops from 30% to 5% in one year then rises again)
- ✓ Check for a possible change of control – should the IRC §382 limitation apply
- ✓ Investigate current audit results that are inconsistent with audit findings in prior cycles
- ✓ When a current audit determines a substantial error has been made, the auditor should evaluate the likelihood that the same error in prior years will generate tax attribute carry forwards
- ✓ If it is likely the same error was made in prior years and the effect is significant, taxpayers should be asked to determine whether or not the same error did occur and document any relevant facts
- ✓ If significant adjustment is indicated, recalculation should be performed even if the net

- effect on the current audit year is minimal
- ✓ When the audit is complete, workpapers provided to the taxpayer should include those relative to determining the proper amount of carry forward available at the end of the audited period
- ✓ If a new audit for a later period occurs, such workpapers will allow the auditor to rely on the prior year figures
- ✓ If during a subsequent audit a significant issue surfaces that actually went unnoticed in the prior period, the auditor should discuss it with the supervisor or manager

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### **9.7 The Non-Income Measure of Excise**

Business Corporations (but not Financial Institutions or pre-2014 Utility Corporations) are subject to a non-income measure of excise in addition to the tax measured by income. The tax is calculated at \$2.60 per \$1,000 of either (a) tangible property located in the commonwealth and not subject to local taxation or (b) an apportioned share of the corporation's net worth less property subject to local taxation and investments in 80% owned subsidiaries. An S Corporation that is not a Financial Institution S Corporation does pay the non-income measure of excise regardless of whether its gross receipts are \$6 Million or more. Note that the non-income measure applies to a corporation doing business in Massachusetts even if that corporation is not subject to an income measure pursuant to federal Public Law 86-272 (see the last paragraph of [M.G.L. c. 63 § 39](#)).

A corporation is classified as either a "tangible property corporation" or an "Intangible property corporation" based on a formula calculation in the statute ([M.G.L. c. 63 § 30.10](#)). The corporation is a "tangible property corporation" if the net book value of the corporation's tangible property situated in the Commonwealth on the last day of the taxable year and not subject to local taxation is 10% or more of the product of (1) its total assets excluding the net book value of any Massachusetts assets taxed locally and (2) its investments in subsidiary corporations in which it owns 80% of the voting stock multiplied by the apportionment percentage determined under [section 38](#). The statute also provides that a corporation may be classified as a tangible property corporation if in the judgement of the commissioner, the corporation should be classified as an tangible property corporation.

A business corporation that does not meet the 10% threshold (or, a corporation which, in the judgement of the commissioner, should be so classified) is an "intangible property corporation." See ([M.G.L. c. 63 § 30.11](#)).

The non-income measure of excise is based on the value of the corporation's property that is not subject to local taxation (taxed by the city or town in which it resides). What property of a business corporation that is subject to local taxation is primarily determined under [M.G.L. c. 59 § 5](#), which specifies the property exempt from taxation in spite of the general rule that all property in the commonwealth is taxable unless there is a law that says otherwise (be aware that Motor Vehicles registered for use on the roads are subject to local taxation under c. 60A).

The sixteenth clause of chapter 59, section 5 exempts "... (2) in the case of a business corporation subject to tax under section 39 of chapter 63 that is not a manufacturing corporation or a telephone corporation subject to chapter 166, all property owned by the corporation other than the following: -- real estate, poles, underground conduits, wires and pipes and machinery used in the conduct of the business, which term, as used in this clause, shall not be considered to include stock in trade or any personal property directly used in connection with dry cleaning or laundering process or in the refrigeration of goods or in the air-conditioning of premises or in any purchasing, selling, accounting or administrative function."

Paragraph (1) of the same clause addresses manufacturing corporations, which are covered by the same "all property other than" approach but have a narrower list of what local taxation can reach (notably that all machinery of a manufacturing corporation is exempt unless it is used in manufacture or in supplying or distributing water).

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### **9.7.1 The "Schedule A" Balance Sheet**

Business corporations filing a chapter 63 return in Massachusetts enclose a balance sheet ("Schedule A") as of the end of the taxable year reporting the net book value of their property, including their tangible property located in the commonwealth. The valuation of assets and liabilities on this balance sheet is expected to conform to the amounts shown on the books and records that are maintained for reporting to shareholders. In the case of a corporation that is selling its assets or liquidating and terminating its business. This balance sheet should reflect the value of that property at the beginning of the day of final disposition or liquidation (see [DD 07-8](#)). The property shown on a corporation's Schedule A must include the consolidated assets and liabilities of any QSUB or disregarded entity owned by the taxpayer (including the assets of a wholly owned DISC, if applicable). In the case of a corporation which owns a general or limited partnership interest, and the corporation and the partnership are required to be included in the same consolidated or combined financial statement under GAAP, the corporation may elect to consolidate its activities in the manner required by GAAP when computing the non-income measure (thus property of the partnership that is subject to local taxation is not treated as taxable again on the corporation's return). See 830 CMR 63.38.1(12)(e)3.

The asset categories on this "Schedule A" balance sheet correspond in part to the categories of property that are excluded in the calculation of the non-income measure of taxation. The taxpayer generally uses this schedule and the corporation's apportionment schedule to determine (first) if the corporation is a tangible or an intangible property corporation and (second) the amount of the excise calculated under the applicable rule. Under normal circumstances this is a very mechanical calculation once the balance sheet is completed, but occasionally property that would be exempt from local taxation is not (such as property exempted under a TIF agreement between the taxpayer and the city or town). In such cases the taxpayer's classification and the calculation of the excise are based on what is actually taxed at the local level.

Note that while M.G.L. c. 63 § 30.7 directs taxpayers to use their books and records in filing the return, and while [National Amusements Inc. v Commissioner of Revenue](#) Docket # F251216 affirms that the Department may not require the taxpayer to use a different method of accounting for the tax return than the method used for the shareholders even when another method might be more appropriate under accounting principles, M.G.L. c. 63 § 39A allows the Commissioner to make adjustments not just to income but to inappropriate accounting reserves and to disregard indebtedness owned or guaranteed by an affiliate in certain circumstances in determining taxable net worth. Further, the recent ATB decision in [National Grid Holdings, Inc. v. Commissioner of Revenue \(National Grid I\)](#) affirms debt equity analysis is appropriate.

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### 9.7.2 Non-Income Measure Computations

The Non-Income Measure calculation is normally very mechanical. In order to calculate the appropriate tax, certain line items on Schedule A are transferred to Schedule B for a classification test and then to either:

- Schedule C (taxable tangible property for a “tangible property corporation” under M.G.L. c. 63, § 30.7),
- Schedule D (taxable net worth for a “intangible property corporation” under M.G.L. c. 63, § 30.8), or
- Schedule RNW (used to calculate the taxable net worth of a publicly traded REIT under M.G.L. c. 63, § 30.9)
- 

When reviewing these schedules auditors should be alert to entries which do not match the related schedule (these should be minimal in an electronic return).

The final tax computation is normally done at a rate of \$2.60 per \$1,000 of the taxable amount. In the event the taxable year is a year of less than 12 months, the excise is prorated based on the number of months in the taxable year, with partial months of 15 days or more generally treated a full months (see [DD 07-8](#)).

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### 9.7.3 Schedule A – Audit Checklist

The following steps should be taken as a starting point in planning a review of a corporation’s non-income measure calculations. At all times the auditor is expected to bear in mind the audit risk (in dollar terms) of an issue – focus on issues that are likely to result in changes that have significant effect and avoid spending time on insignificant issues. It may be appropriate to test the value of some possible changes using the audit workpapers package before beginning a detailed investigation. In some cases, the non-income measure may change substantially even without a balance sheet review (as when you determine that the apportionment percentage should be 80% instead of 20%) and the auditor may find that a detailed review of modest reserves claimed by the taxpayer on schedule A may not be cost-effective.

- ✓ Review book-to-tax work papers. These should show what trial balance accounts are mapped to what lines on the federal Schedule L. Verify that the starting point matches the trial balance detail you were provided, and that the ending point matches Schedule L on Form 1120.
- ✓ Compare federal Schedule L and Massachusetts Schedule A. The figures reported on both schedules are based on net book value at the end of the tax year, and the figures should correspond except for the division of some categories on one form into multiple categories on another.
- ✓ If the issue is potentially significant, review the taxpayer's division of tangible assets between the "in Massachusetts" and "outside of Massachusetts" categories. Verify that the reserves appear appropriate and that they have also been divided consistent with the assets to which they relate.
- ✓ Be alert for the possibility of significant property transfers that may have occurred around the last day of the year, particularly if they were reversed afterwards. [M.G.L. c 63 § 30.7](#) allows the commissioner to compute the tangible property measure (if applicable) using average property values if the taxpayer has acted to reduce its excise in this manner. The issue may also affect apportionment.
- ✓ Evaluate taxpayer's assignment of property between "taxed locally" and "not taxed locally." Motor Vehicles, Land, Buildings, and Leasehold improvements are almost always taxed locally. This may be more significant if a taxpayer with a high net worth is filing as a tangible property corporation with a relatively low tangible property percentage.
- ✓ Review the detailed list of items included in "Other Assets" and verify that none of it is actually tangible property (e.g. canned computer software is considered tangible property. Capitalized costs of custom software are not).
- ✓ Investigate any contingent liabilities and determine if they represent reasonable reserves. See [830 CMR 63.30.1](#) for examples of adjustments with respect to liabilities in determining the non-income measure of excise.
- ✓ Identify and review the treatment of Construction Work in Process. A portion of CWIP is typically property that is not taxed locally and, although multiple projects may be lumped together on the balance sheet, they should be broken out when calculating the non-income measure (a 15% safe harbor percentage is discussed in [DOR Directive 02-11](#)).
- ✓ If taxpayer's Schedule A classifies some of its property as "exempt goods," determine what the property in question was and verify that the goods are exempt.

Some issues on the balance sheet may require the auditor to take a second look at the net income computations:

- ✓ Review any related party loans and evaluate whether or not there is a true debtor-creditor relationship (i.e. whether such notes represent valid debt). If the lender qualifies as a related member, the addback statute may be an issue. Further, [M.G.L. c. 63 § 39A](#) authorizes the commissioner to disregard amounts due to or guaranteed by an affiliate corporation if a corporation's capital is insufficient. Treating such a loan as a capital contribution may also affect the calculation of income for both parties (e.g. if there is no loan, payments to the stockholder may be dividends and therefore not deductible in determining net income).
- ✓ If the taxpayer's Schedule L shows tax exempt securities, verify that any interest income has been included in the computation of Massachusetts Net Income. Note also that [IRC](#)

[Section 265\(a\)\(2\)](#) disallows the deduction of any interest paid to purchase these securities and deductions not allowed federally (this should be on the schedule M) are not allowed for Massachusetts purposes absent a specific statutory authority.

- ✓ A large balance payable to employees for bonuses at year end should be checked. If the taxpayer deducted the bonus in determining income, verify that it was actually paid within 75 days of the end of the year. If the bonus was paid to shareholder-employees, evaluate whether or not it was actually a dividend (and therefore not deductible at all).

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## 9.8 Credits

Corporate taxpayers may qualify for any of several possible tax credits against excise based on their activities or their investments. A few credits are more tightly controlled, requiring that in addition to performing the qualifying activities or making the qualifying investments, the taxpayer must seek prior authorization from a state board or agency and secure approval to claim the credit. The board or agency may impose conditions on the credit (amount, year in which it may be taken, etc.) and may require other commitments by the taxpayer (e.g. to increase the number of employees in Massachusetts) with the taxpayer's compliance with those commitments subject to review by the state board or agency as a condition of authorizing the credit.

The general rule is that credits available to corporations may be used to reduce the excise but, with rare exceptions, they are not refundable. Depending on the specific statute authorizing the credit or other related statutory provisions, the amount of credit that can be taken may be:

- limited to a portion of the excise,
- carried over to future years if not used in the year in which they are earned,
- shared between shareholders, members, or taxpayers participating a combined report, and/or
- transferable between taxpayers (corporation X is allowed to buy a credit from corporation Y),

A corporation may be entitled to take more than one type of credit. The usage of credits is coordinated in their application; taxpayers are allowed to choose the order in which credits are used and the amount of each credit used but are not permitted to disregard any of the limitations. If a taxpayer is eligible to take two credits, both of which are subject to the provision limiting credits to not more than 50% of the amount otherwise due or the minimum excise, no ordering of the credits will allow the taxpayer to offset more excise than is allowed to be offset under these limitations. In this scenario, the exact terms of the limitations matter: if one limitation is that the credit may not be used to reduce the excise below 50% of the amount otherwise due but not below \$456, and the second limitation is that the credit is limited to 75% of excise determined under §39 but may not be used to reduce the tax below \$456, a taxpayer with sufficient credits available may reduce its excise down to \$456 (use the 1<sup>st</sup> credit to cut the excise in half and whatever remains has to be less than 75% of the excise determined under section 39, which is the excise before any credits are taken).

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### 9.8.1 Types of Credits Available to Corporations

Tax credits are authorized by specific statutory provisions. Credits available to corporations are generally found in various sections within chapter 63. As of the date of publication of this procedure, the following credits may be available to a corporate taxpayer (they are listed below in the order in which they appear on the 2014 schedule CR).

**EDIP Credit (M.G.L. c. 63, § 38N for projects certified on or after January 1, 2010)** – The Economic Development Incentive Program credit is only available to taxpayers as authorized by the economic assistance coordinating council (“EACC”) established by section 3B of chapter 23A. The credit is available to any corporation taxable under M.G.L. c. 63. The credit is also available to M.G.L. c. 62 taxpayers.

The EACC may authorize credits to multiple taxpayers but the aggregate amount of all such credits allowed to all taxpayers for a specific year is subject to a legislative cap (not more than \$25 Million annually from 2010 through 2014 or \$30 Million for years 2015 through 2019, subject to further legislative action). To control this, the EACC authorizes specific taxpayers to take a specific amount of credit in a specific year. Taxpayers receive a written authorization from the EACC detailing the terms of any credit allowed and any limitations on that authorization.

**Taxpayers also receive from the EACC a certificate number which must be used on the return to claim the credit.**

Authorized taxpayers may take the credit *provided* they also perform certain specific economic activities such as:

- i.) Credits may be allowed for investments in certified expansion projects or certified enhanced expansion projects at a rate set by EACC for the specific project that may not exceed 10% of the cost of the eligible fixed assets placed in service in the project.
- ii.) Credits may be allowed for investments in certified manufacturing retention projects at a rate set by EACC for the specific project that may not exceed 40% of the cost of the eligible fixed assets placed in service in the project.
- iii.) Credits may be allowed for certified job creation projects at a rate, determined by the EACC for the specific project, of up to \$1,000 per job created in the project (or up to \$5,000 per job created for projects in certain cities and towns) The credit is allowed only for the year subsequent to the year in which the job is created and was added to section 38N for 2015. See [TIR 14-13](#).

Qualifying Investments made for the EDIP credit must generally meet the same standards as the Massachusetts investment tax credit (ITC) (depreciable property with a useful life of 4 years or more under the Code and not taxable under M.G.L. c. 60A - see [M.G.L. c 63 § 31A\(i\)](#)). In addition, EDIP credit is allowed with respect to real property leased under an operating lease (property that would not qualify under §31A) and used exclusively in the project. Corporations eligible to take the ITC may take both the ITC and the EDIP credit in the same year, but both credits may not be taken for the same asset.

If the amount of the investment times the specified rate for the project, or the number of

new jobs times the specified per job rate for the project, is less than the amount of credit authorized by the EACC, the credit is the lower amount. Regardless of the dollar value of the qualifying investments, the amount of EDIP credit may not exceed the specific amount authorized by the EACC.

The amount of credit taken by a corporation may not exceed 50% of the corporation's excise for the year *unless and to the extent that*, in the case of a certified manufacturing retention project or a certified job creation project, the EACC authorizes a refund of the unused portion of the credit and the taxpayer elects to take the refund, in which case the limitation on use does not apply. A carryover of up to 10 years is allowed, but no credit may be taken more than 5 years after the termination of the project and the EACC may, in granting the credit, limit the carryover.

**EDIP credit is subject to recapture if property for which the credit has been allowed ceases to be in qualified use or ceases to be used exclusively in the certified project before the end of its useful life.**

The EDIP credit is also allowable to M.G.L. c. 62 taxpayers. If an S corporation is authorized by the EACC and performs the required economic activity required to claim the credit, then either the corporation or the shareholder(s), but not both, may take the credit with respect to any eligible property. Once an election to pass the credit through to the shareholders of an S corporation has been made, the credit belongs to the shareholders and is used according to the rules of chapter 62. If a shareholder is unable to take the full amount of the credit, it may carry over any unused portion subject to any restrictions that may have been placed on carry over by the EACC. If recapture is required, the shareholders must recapture.

**EOA Credit (M.G.L. c. 63, § 38N for projects certified on or before December 31, 2009)** – Prior to 2010, the economic assistance coordinating council (“EACC”) established by section 3B of chapter 23A supervised a different tax credit program. The pre-2010 credit is available to any corporation taxable under M.G.L. c. 63 and is also available to M.G.L. c. 62 taxpayers (but in each case only for projects certified on or before December 31, 2009.) taxpayers. As with the EDIP credit discussed above, EOA credits are allowed only for certified projects which are in an Economic Opportunity Area (“EOA”). With respect to corporate tax credits, the primary differences between the pre-2010 program and the current program are:

- (a) In certifying a pre-2010 project, the EACC did not authorize a specific amount of credit or require the credit to be taken in a specified year. The credit was allowed for qualified investments in the certified project without a limitation on the amount of credit;
- (b) There was no cap on the aggregate total of credit that could be taken by all taxpayers participating in pre-2010 projects;
- (c) The credit was not allowed for pre-2010 projects with respect to real property that was leased pursuant to an operating lease;
- (d) The credit was always calculated at 5% of the eligible investment for pre-2010 projects;
- (e) The EACC had no authority to limit carry credits for pre-2010 projects;
- (f) The credit was not refundable without a special act of the legislature;
- (g) Administratively, no certificate number was issued by the EACC.

Under both the old and the new programs, projects are certified for a specified number of years (up to 20 years in many cases). The revisions to the statute that created the EDIP did not significantly affect the projects authorized under the prior version of M.G.L. c. 63, § 38N. Projects certified under the old rules continue to follow the old rules until the project is decertified (by the EACC) or the time period specified in the project agreement expires. See [TIR 10-1](#) for a discussion of the differences between the rules that apply to projects certified before and after January 1, 2010.

Qualifying Investments made for the EOA credit must generally meet the same standards as the Massachusetts investment tax credit (depreciable property with a useful life of 4 years or more under the Code and not taxable under M.G.L. c. 60A - see M.G.L. c 63 § 31A(i)) and used exclusively in the project. Corporations eligible to take the ITC may take both the ITC and the EOA credit in the same year, but the same asset may not be submitted for both credits. The provisions of [830 CMR 63.38N.1](#) apply to the EOA credit.

The amount of EOA credit taken by a corporation may not exceed 50% of the corporation's excise for the year. A carryover of up to 10 years is allowed, but no EOA credit may be taken more than 5 years after the termination of the project and the EACC may, in granting the credit, limit the carryover. **EOA credit is subject to recapture when property for which the credit has been allowed ceases to be in qualified use or ceases to be used exclusively in the certified project before the end of its useful life.**

The EOA credit is also allowable to M.G.L. c. 62 taxpayers. If an S corporation is authorized by the EACC and performs the required economic activity required to claim the credit, then either the corporation or the shareholder(s), but not both, may take the credit with respect to any eligible property. Once an election to do so has been made, the credit belongs to the shareholder and is used according to the rules of chapter 62. If a shareholder is unable to take the full amount of the credit, it may carry over any unused portion subject to any restrictions that may have been placed on carry over by the EACC. **If recapture is required and the credit was taken by the shareholders, the shareholders must recapture.**

**ITC (M.G.L. c. 63, § 31A(i))** – The investment tax credit (“ITC”) is allowed to manufacturing corporations, business corporations engaged primarily in research and development, and to corporations primarily engaged in agriculture or commercial fishing, and may be claimed against such corporations’ excise under chapter 63. Note that subsections (a) and (i) of section 31A are very similar, but (a) only applies to years before 1994. Since (i) invariably applies to the years under audit, it should be cited as the reference. **Financial institutions and utility corporations are not eligible to claim the ITC, and, except as noted above, most business corporations similarly fail to qualify**

- ✓ To qualify as a manufacturing corporation under the provisions of [M.G.L. c. 63, § 42B](#), a corporation must be engaged in substantial manufacturing within Massachusetts. What constitutes manufacturing and the numeric tests to determine what is substantial are discussed in section 9.1.2 of this procedure.
- ✓ To qualify as a corporation engaged primarily in research and development for the purpose of claiming the ITC under M.G.L. c. 63, § 31A, a corporation must have

research and development as its primary activity and 2/3 of its receipts attributable to the commonwealth must be from this activity. The text of M.G.L. c. 63, § 42B allows a corporation to qualify as an R&D corporation based on an expenditures test, but denies it the ITC unless it also meets the receipts test.

- ✓ There is no strict numerical test for whether or not a corporation is engaged primarily in agriculture or commercial fishing, and the statute does not require that the agriculture or commercial fishing occur within Massachusetts. See [Commissioner of Revenue v Cargil, Inc. 706 N.E.2d 625, 429 Mass. 79 \(1999\)](#).

While the statutory reference for manufacturing and R&D corporations is to a corporation which has been “deemed to be such under” 42B, formal classification is not a factor. The test is whether the taxpayer is actually performing the qualifying activity (substance over form, see [TIR 86-3](#)). A taxpayer is not required to file an application to be classified as a manufacturing (or an R&D corporation) to claim the ITC. The taxpayer must simply be engaged in activities that meet the standards for classification.

A corporation that meets one of the above requirements is allowed an ITC of 3% of the cost (or other basis for federal income tax purposes) of qualifying tangible property. Qualifying property must not be taxable under chapter 60A (registered motor vehicles) and be:

- Used by the corporation in the commonwealth (property leased to others is excluded);
- Situated in the commonwealth on the last day of the taxable year; and
- Depreciable under section one hundred and sixty seven of said Code and have a useful life of four years or more.

It is not necessary that use of the property be in the activities which make the corporation eligible for the credit (see *Cargil* above.) All of the Massachusetts property of a manufacturing corporation (unless excluded by one of the 4 tests shown above) is eligible for the credit even if a particular asset is not used in manufacturing operations.

A corporation that is eligible may also claim the ITC with respect to tangible personal property leased under an operating lease. The statutory formula allows an eligible corporation to claim the ITC that it would have received had it purchased the property over the useful life of the property (if the property has a 60 month life, the corporation would claim the credit based on the number of days it leased the property during the year divided by the total useful life of the property, also in days). Separately, a corporation may also claim the ITC for property leased from a regional business development corporation treating the property as if it was purchased by the taxpayer.

The ITC is subject to the 50% limitation in [M.G.L. c. 63, § 32C](#). Under that section, the maximum amount of credits otherwise allowable in any one taxable year to a corporation cannot exceed 50% of the excise imposed under section 39. Unused ITC may be carried forward to the next three succeeding taxable years (see § 31A(g)). The last sentence of section 32C allows for carryover of credit that cannot be taken solely because of the 50% limitation to any subsequent year.

ITC is subject to recapture when property for which the credit has been allowed ceases to be in qualified use before the end of its useful life. This includes:

- All property of the corporation when it ceases to qualify for the ITC. Note that this may be in the middle of a taxable year (such as when a corporation sells its factory in Massachusetts), and although the tax is due at the end of the year the recapture is calculated based on the date of the event;
- Property sold, destroyed or otherwise removed from service;
- Property that is no longer used in Massachusetts, even if it is still used by the corporation;
- Property leased to others;
- Property that is transferred to an affiliate that is not qualified to take the ITC.

Recapture is not required if the property has been in qualified use for more than 12 consecutive years.

Determining Basis for MA Investment Credits – the expensing of deductions under IRC § 179 and the depreciation and bonus depreciation deductions under IRC §§ 167 and 168 impact the basis (or cost) on which the ITC and the economic development incentive credits (the “MA investment credits”) are calculated. As of this writing, [Working Directive 15-XX](#) instructs that the basis to be used is the taxpayer’s initial adjusted basis used for computing federal depreciation deductions upon acquisition, construction, reconstruction, or erection of the property (the “federal depreciable basis”). IRC § 179 and its regulations require that such federal depreciable basis be reduced to account for any properly-elected IRC § 179 deduction to expense the cost of the property. This basis reduction is similarly required for Massachusetts tax purposes, and the Massachusetts investment credits may only be claimed to the extent of any remaining basis in the property after such reduction. However, no reduction in federal depreciable basis is required with respect to first-year depreciation and bonus depreciation deductions when calculating the Massachusetts investment credits. See [Working Directive 15-XX](#) for further details.

**Vanpool Credit (M.G.L. c. 63, § 31E)** - The Vanpool Credit is available to business corporations and S Corporations taxable under §§ 32D and 39 (**but not Financial institutions, Utility Corporations, etc.**) that operate a company shuttle van (as defined in [M.G.L. c 63 § 31D](#)). The credit is 30% of the costs incurred during the taxable year for the purchase of a company shuttle van, but if the credit is taken, the depreciation deductions for the van must be recalculated to reflect a reduction in basis for the van equal to the amount of credit allowed. A credit is also allowed for 30% of the cost to lease such a van, excluding insurance, maintenance, driver’s salaries, fuel, finance charges or other operating expenses, to the extent that these expenses may be included in the cost.

The Vanpool Credit is subject to the 50% limitation in [M.G.L. c. 63, § 32C](#) discussed above and is not subject to carryover, except as noted in section 32C, nor may it be claimed to reduce the excise below \$456. **The credit is subject to recapture if the van ceases to be used as a company shuttle van.**

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**Research Credit (M.G.L. c. 63, § 38M)** - The Research Credit is available to business corporations and S Corporations taxable under §§ 32D and 39 (**but not Financial institutions, Utility Corporations, etc.**). The credit is allowed for 10% of the excess of qualified research expenses over a base amount (which, under the statute, varies by the taxable year but is no less than 50% of the qualified research expenses). Qualified research expenses for the Massachusetts credit are defined as those qualified for the federal credit under IRC § 41 with the additional requirement that the research must be performed in Massachusetts. The statute also allows a credit for 15% of “basic research payments” under IRC § 41(e)(1)(A), but this is extremely rare. A taxpayer who is allowed a credit under this section must reduce its otherwise allowable deductions for research expenses by the amount of the credit allowed, whether or not the credit is actually taken in the same year.

In calculating the credit, Massachusetts (like the federal credit) requires aggregation of activities for entities under common control. All of the business entities combine their qualified expenses and activities as if they were a single taxpayer (intercompany transactions wash out) and determine a single credit for the group. This includes business entities that may not be part of a Massachusetts combined report such as an insurance company. The group’s total credit is then attributed to the members based on their share of the qualified expenses, again ignoring the intercompany payments.

Qualified research expenses, for both federal and state purposes, are limited to:

- wages paid for qualified services, with qualified services defined as (personally) engaging in qualified research, individuals engaging in the direct supervision or direct support of research activities which constitute qualified research. The statute provides that where “substantially all” (defined elsewhere as 80% or more) of the services performed by one employee for the taxpayer are for qualified research, all of that employee’s services are considered “qualified services”). See IRC § 41(b)(2)(B);
- expenditures for supplies used in the conduct of qualified research;
- amounts paid to another person for the right to use computers in the conduct of qualified research (the statute dates from a decade when the rental of computer time was relatively common); and
- 65% of contract research expenses which include amounts paid to non-employees for performing qualified research (IRC § 41(b)(3) subparagraphs (C) and (D) were added to the Code in 1996 and 2005 and do not apply the amount under M.G.L. c. 63 §38M which defines qualified research expenses in terms of the Code as of August 12, 1991.)

Wages for this purpose are defined under IRC § 3401, which includes stock-based compensation but excludes amounts deferred by the employee to a 401K plan.

Only amounts incurred for qualified research are eligible for the credit. The IRC s 41(d) definition of what is qualified research for the credit starts with activities that qualify for expensing under IRC s 174 and then narrows it:

- (1) In general – The term “qualified research” means research –
  - (A) With respect to which expenditures may be treated as expenses under section 174
  - (B) which is undertaken for the purpose of discovering information –

- (i) which is technological in nature, and
  - (ii) the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and
  - (C) substantially all of the activities of which constitute elements of a process of experimentation for a purpose described in paragraph (3)
- such term does not include any activity described in paragraph (4)
- (2) Tests to be applied separately to each business component. - ...
  - (3) Purposes for which research may qualify for credit. For purposes of paragraph (1)(C)
    - (A) In General – Research shall be treated as conducted for a purpose described in this paragraph if it relates to –
      - (i) A new or improved function,
      - (ii) Performance, or
      - (iii) Reliability or quality
    - (B) Certain purposes not qualified – Research shall in no event be treated as conducted for a purpose described in this paragraph if it relates to style, taste, cosmetic, or seasonal design factors
  - (4) Activities for which credit not allowed – the term “qualified research” shall not include any of the following.
    - (A) Research after commercial production - ...
    - (B) Adaptation of existing business components - ...
    - (C) Duplication of existing business component - ...
    - (D) Surveys, studies, etc.- ...
    - (E) Computer software – except to the extent provided in regulations, any research with respect to computer software which is developed by (or for the benefit of) the taxpayer primarily for internal use by the taxpayer, other than for use in –
      - (i) An activity which constitutes qualified research (determined with regard to this subparagraph), or
      - (ii) A production process with respect to which the requirements of paragraph (1) are met.
    - (F) Foreign research - ...
    - (G) Social Sciences, etc. - ...
    - (H) Funded research – Any research to the extent funded by any grant, contract, or otherwise by another person (or governmental entity).

The research credit is subject to a limitation of \$25,000 plus 75% of the excise over \$25,000 determined before application of any credits (see G.L. C 63, §38M(d)), with the restriction that it may not reduce the excise below the minimum excise for a business corporation (\$456) (see §38M(c)). The regulation (830 CMR 63.38M.2(11) includes an example that clarifies that a taxpayer may use the research credit in combination with the investment tax credit to reduce its tax liability down to \$456. The regulation (830 CMR 63.38M.2(a)2. also provides that, in the case of an aggregated group, the \$25,000 amount that is not subject to the 75% limitation is divided among all the members of the group in proportion to their separate excise under section 39. Any portion of the credit not used may be carried over for a period of 15 years, with unlimited carryover for any portion not allowed because of the 75% of excise limitation.

Under the Massachusetts Life Sciences Tax Incentive Program, the Massachusetts Life Sciences Center may authorize a taxpayer to have a portion of its unused credit refunded. In such a circumstance (rare) the portion of the tax that exceeds the \$38M limitation does not change but the refundable credit may offset that. See e.g., [TIR 13-6](#), Example #3.

Changes in the calculation of the Research Credit for 2015 and subsequent years –

Prior to 2015, the calculation of the credit was as described above, with the base amount determined under the Code as of August 12, 1991. For taxpayers with at least 3 years of both sales and qualified research expenses in the years 1984 through 1989, the base amount was determined using a “fixed base percentage” calculated as the ratio of qualified expenses to sales in those years (not more than 16%). For taxpayers without 3 years during the 1984-1988 period in which they had both sales and qualified research expenses, a fixed base percentage of 3% was used. In either case, the “base amount” was the fixed base percentage multiplied by the taxpayer’s average annual receipts from the 4 years immediately prior to the credit year.

For tax years beginning on or after January 1, 2015, the fixed base percentage becomes the “fixed base ratio” and is calculated using the qualified research expenses for the 4 years immediately prior to the credit year (it still cannot exceed 16%). The base amount is now the “ratio” times the average annual receipts.

Effective for tax years beginning on or after January 1, 2015, a business corporation may elect to calculate its research credit under an alternative method that uses 50% of the average of the taxpayer’s qualified research expenses for the last 3 years in place of the base amount: This MA alternative simplified credit will be phased in over a seven year period as follows:

(a) For calendar years 2015, 2016, and 2017, the amount of the credit is equal to 5% of the taxpayer’s qualified research expenses for the taxable year that exceed 50% of the taxpayer’s average qualified research expenses for the 3 taxable years preceding the taxable year for which the credit is being determined.

(b) For calendar years 2018, 2019 and 2020, the amount of the alternative credit is 7½% of the taxpayer’s average qualified research expenses that exceed 50% of the taxpayer’s average qualified research expenses for which the credit is being determined for the preceding 3 taxable years.

(c) For calendar years beginning on or after January 1, 2021, the amount of the alternative credit will be 10% of the taxpayer’s qualified research expenses for the taxable year for which the credit is being determined that exceed 50% of the taxpayer’s average qualified research expenses for the preceding 3 taxable years. If the corporation does not have qualified research expenses in any one of the three taxable years preceding the taxable year for which the credit is being determined, the amount of the Massachusetts alternative simplified research credit will be equal to 5% of the taxpayer's qualified research expense for the taxable year.

See [TIR 14-13](#), Part I. See also [TIR 14-16](#), Part I (providing technical corrections to the Massachusetts alternative simplified research credit).

**The research credit is *not* subject to recapture except when, and only to the extent that, the credit was converted to a refundable credit under the life sciences tax incentive program. See TIR 13-6, example #4**

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**Harbor Maintenance Tax Credit (M.G.L. c. 63, § 38P)** – The Harbor Maintenance Tax Credit is available to business corporations and S Corporations taxable under §§ 32D and 39 (**but not Financial institutions, Utility Corporations, etc.**). The credit is allowed for the full amount of any tax paid to the federal government by a corporation as a shipper, importer or exporter pursuant to IRC §4461 subject to the following limitations: (1) the tax must be paid with respect to the shipment of break-bulk cargo or containerized cargo; (2) the tax must be paid with respect to shipment by sea and ocean-going vessels through ports located in the commonwealth; and (3) the tax paid with respect to passengers, the shipment of bulk cargo or the shipment of any other cargo or item or commerce not included within the meaning of clause (1) hereof is not qualifying harbor maintenance tax.

Harbor Maintenance Tax Credit may not reduce the corporation’s excise below \$456. It is explicitly not subject to the 50% of excise limitation in [M.G.L. c. 63, § 32C](#). If not used, it may be carried forward to any of the 5 succeeding taxable years. **The Harbor Maintenance Tax credit is not subject to recapture.**

**Brownfields Credit (M.G.L. c. 63, § 38Q)** – Any corporation which commences and diligently pursues an environmental response action and achieves and maintains a permanent solution or remedy operation status in compliance with chapter 21E is allowed a credit of 25% or 50% of the net response and removal costs. The credit is not available to a corporation that is subject to an enforcement action. A parallel credit allowed under c. 62.

A taxpayer seeking the credit must first file a documentation of a permanent solution or a remedy operation status with the Department of Environmental Protection (“DEP”). The taxpayer next submits a Brownfields Credit Application (“Form BCA”) to the DOR. When DOR approves the application, the taxpayer will receive authorization to claim a specific amount of Brownfields Credit together with a certificate number which must be used to claim the credit. Taxpayers may use the credit on their own returns, or they may transfer it (sell it) to another taxpayer by filing Form BCTA with the Department. A non-profit corporation that pursues a environmental response actions is eligible to claim and transfer the credit. See chapter 121 of the Acts of 2006.

The Brownfields Credit may not reduce a business corporation’s tax below the minimum excise. It is subject to the 50% limitation provision in 32C (which applies to business corporations), but is not eligible for the unlimited carryover in that section. Any unused portion may be carried over for up to 5 years. **The credit is subject to recapture if the taxpayer fails to maintain the environmental remedy, but to date this has rarely occurred.**

**Low-Income Housing Credit (M.G.L. c. 63, §31H)** – Any corporation subject to an excise imposed by chapter 63 is eligible to take a low-income housing credit under this section if they have been authorized to do so by the department of housing and community development (or its successor agency). Credits are granted to the owner(s) of qualified low-income housing projects as an incentive with the goal of increasing the commonwealth’s stock of affordable housing units. Credit awards are for a specific amount and are issued in certificate form and may be used by the taxpayer or transferred (sold) by application to the Department of Revenue.

The credit allotted is to be taken against the excises imposed under chapter 63, is to be claimed equally over 5 years, and is not refundable. The amount of the credit that exceeds the excise due for a taxable year may be carried forward to any of the five subsequent taxable years. **The credit is subject to recapture if the federal low income housing credit for the same project allowed under IRC section 42 is subject to recapture.** The state recapture amount is equal to the amount of the state credit previously claimed times a fraction, the numerator of which is the amount of the recaptured federal credit and the denominator of which is the amount of the federal credit previously claimed. A parallel credit allowed under c. 62.

**Historic Rehabilitation Credit (M.G.L. c. 63, § 38R)** – Any taxpayer may be allowed a credit for up to 20% of the costs of qualified rehabilitation expenditures made by the taxpayer with respect to a qualified historic structure. The credit is allowed for the year in which the structure is placed in service and has received “final certification” that the work has been completed as proposed and the costs qualify as qualified rehabilitation expenditures. The Massachusetts Historical Commission administers and determines eligibility for the credit and determines and accounts for the amount of the credit available for allocation. See [830 CMR 63.38R.1](#).

Credits are not refundable but may be transferred (sold) by application to the Department of Revenue. Unused credit may be carried forward for up to 5 years from the year in which the rehabilitated property is placed in service. The credit is not subject to the 50% of excise limitation of section 32C but may not reduce the excise below the minimum excise provided in section 39. **Recapture is required if before the end of the 5 year period beginning on the date on which the qualified historic structure received final certification and was placed in service, the taxpayer disposes of the taxpayer’s interest in the structure.** A parallel credit allowed under c. 62.

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**Film Incentive Credit (M.G.L. c. 63, § 38X)** – A motion picture production company engaged in the making of a motion picture (including videos, digital media projects, commercials, television shows, etc. but not including productions featuring news or sports, talk shows, awards shows, etc.) shall be allowed a credit equal to 25% of certain Massachusetts payroll costs if the production costs incurred in the commonwealth exceed \$50,000. A further credit of 25% of Massachusetts production costs (excluding the payroll costs for which credit was already given) is allowed if more than 50% of the production expenses are in Massachusetts or more than 50% of the principal photography days for a film take place in the commonwealth. The credit may be taken by any corporation taxable under chapter 63. A parallel credit is allowed under chapter 62.

A motion picture production company seeking to claim the credit must submit an application, [Form FP](#), with appropriate documentation, to the Department of Revenue. After review and to the extent the department determines the application should be approved, the taxpayer will receive written documentation of the amount of credit allowed, including a certificate number which must be used to claim the credit. At the election of the taxpayer, a motion picture company that has been awarded the credit may apply the credit to reduce or eliminate its chapter 63 excise and receive a refund of 90% of the balance of the unused credits (see [M.G.L. c. 63, § 32E](#).) A motion picture company may alternately carry forward the unused portion of the credit for up to 5 years.

A motion picture company may also transfer (sell) the credit to another taxpayer. A transferee may then apply the credit to its own excise and carry forward any unused balance to any of the 5 subsequent taxable years from which a certificate was initially issued by the Department of Revenue (the transfer does not extend the life of the credit.) **The film credit is not subject to recapture.**

**Medical Device Credit (M.G.L. c. 63, § 31L)** – A “Medical device company” which has a usual place of business within the commonwealth wherein medical devices are developed or manufactured, is allowed a credit against its chapter 63 excise equal to 100% of the amount actually paid by the medical device company to the U.S.F.D.A during the taxable year for pre-market submissions (e.g., applications, supplements, reports, or 510(k) submissions) to market new medical devices or upgrades or changes or enhancements to existing medical devices developed or manufactured in the commonwealth. For a new medical device, or for an upgrade, change or enhancement to an existing medical device to be considered “developed or manufactured in the commonwealth,” more than half the development or manufacturing costs must be incurred in Massachusetts. A similar credit is allowed to chapter 62 taxpayers.

To claim the credit, the medical device company must file an application ([Form MDCA](#)) with the Department of Revenue together with documentation of the costs and, after review, receive authorization to claim a specific amount of credit together with a certificate number that must be provided with the return. See [TIR 06-22](#).

The medical device company may not carry an unused credit over to future years but it may transfer an unused credit to another taxpayer provided the transferee provides private financial assistance to the medical device company in an amount at least equal to 75% of the medical device tax credit eligible for transfer. The transfer of credits must be approved by the commissioner. The transferee may not subsequently transfer the credit a 2<sup>nd</sup> time and must use the credit transferred to it on tax returns filed by it within 5 years, after which period the credit will expire. The credit cannot be used to reduce a transferee’s excise due to below \$456. **The medical device credit is not subject to recapture.**

**Employer Wellness Program Credit (M.G.L. c. 63, § 38FF)** – Any taxpayer subject to tax under chapter 62 or chapter 63 may be authorized by the Department of Public Health (“DPH”) to claim a credit of 25% of the costs associate with implementing an Employer Wellness Program. Taxpayers seeking the credit submit an application to DPH with a proposal and a projected budget for the program. After review DPH will provide the applicant with a certificate with a certificate number that must be submitted with the return and the amount of credit authorized. The maximum amount that may be awarded is \$10,000. See [TIR 12-10](#), Item I.

Corporations may take the credit but may not reduce the excise below the minimum excise. Credits not used may be carried forward for up to 5 taxable years. **The Wellness Program Credit is not subject to recapture.**

**Certified Housing Development Credit (M.G.L. c. 63, § 38BB)** – Any taxpayer subject to tax under chapter 62 or chapter 63 may claim a credit awarded by the Department of Housing and Community Development (“DHCD”) for up to 10% of the costs of qualified substantial rehabilitation expenditures, as define in G.L. c. 40V, § 1, of the market rate units within a certified housing development project.. The credit is awarded by the DHCD in an amount

determined by the DHCD, which may also impose any limitation it deems appropriate on the award, including prohibition on transferring the credit. Qualified expenditures applicable to the credit are deemed made on the date the DHCD gives the Commissioner of Revenue written notification of the completion of the project. See [TIR10-14](#).

The taxpayer may apply the credit to reduce or eliminate its tax liability and unused credits may be carried forward to future taxable years. Taxpayers, unless prohibited by the terms of the award from DHCD, may apply to the Commissioner to transfer (sell) any credits allowed under this section, and the transferee may apply the credit to its own excise and may carry over any unused portion to future years. In no event may either the taxpayer or a transferee carry the credit forward to a taxable year beginning more than 5 years after the date the DHCD notified the Commissioner of the completion of the project. **The Certified Housing Development Credit is not subject to recapture.**

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**Life Science Company Investment Tax Credit (M.G.L. c. 63, §38U)** – A Certified Life Sciences Company, to the extent authorized by the Life Sciences Tax Incentive Program, may be allowed a refundable credit in an amount determined by the Massachusetts Life Sciences Center (MLSC). The MLSC will provide the taxpayer with a written authorization detailing the terms of any credit allowed (including the maximum amount of credit that may be claimed) and the year in which the credit may be taken. Taxpayers also receive from the MLSC a certificate number which must be used on the return to claim the credit.

The credit is allowed for 10% of the cost or other basis of depreciable real or tangible property with a useful life of 4 years or more that is placed in service in the taxable year subject to the maximum credit amount specified by the MLSC. The taxpayer may not take both the LSCITC and the ITC under section 31A or the low income housing credit under section 31H for the same asset. If the taxpayer is eligible to take the EOA credit under section 38N, it may to the extent authorized by the MLSC take that credit on the same property but at a rate of 2% of the cost or other basis.

The credit is not subject to the 50% of excise limitation found in M.G.L. c. 63, s. 32C and, to the extent authorized by the MLSC, the taxpayer may carry the unused portion of the credit forward for up to 10 years. To the extent the credit exceeds the excise due, and only if authorized by the MLSC, 90% of the excess credit may be refunded to the taxpayer. **The credit is subject to recapture if an asset for which the credit is taken is disposed of or otherwise ceases to be in qualified use before the end of its useful life, or if the MLSC decertifies the company's status as a Life Sciences Company.**

**Life Science Company Research Credit (M.G.L. c. 63, s. 38W)** – A Certified Life Sciences Company, to the extent authorized by the Life Sciences Tax Incentive Program, may be allowed a research credit calculated in a manner similar to the credit allowed under M.G.L. c. 63, s. 38M except that the expenses allowable in calculating the credit under section 38W shall include legally mandated clinical trial activities that qualify for the federal credit regardless of whether or not those activities occur inside the commonwealth. The Massachusetts Life Sciences Center (MLSC) will provide the taxpayer with a written authorization detailing the terms of any credit allowed (including the maximum amount of credit that may be claimed) and the year in which the credit

may be taken. Taxpayers also receive from the MLSC a certificate number which must be used on the return to claim the credit. In computing net income under s. 30, the taxpayer must reduce the deduction taken from gross income for the research expenses by the amount of the credit allowed.

The limitation (75% of excise over \$25,000 with aggregation) and carryover (15 Years) provisions are essentially the same as those section 38M except that all terms must be as authorized by the life sciences tax incentive program.

**Life Science Company FDA User Fees Credit (M.G.L. c. 63, s. 31M)** – A Certified Life Sciences Company, to the extent authorized by the Life Sciences Tax Incentive Program, may be allowed a refundable credit in an amount determined by the Massachusetts Life Sciences Center (MLSC). The credit is allowed for 100% of the amount actually paid by a taxpayer to the U.S.F.D.A that constitutes the fee due upon the submission of a human drug application or supplement, the research and development costs of which were primarily incurred in the commonwealth. In computing net income under s. 30, the taxpayer must reduce the deduction taken from gross income for the user fees paid by the amount of the credit allowed.

The MSLC will provide the taxpayer with a written authorization detailing the terms of any credit allowed (including the amount of credit) and the year in which the credit may be taken. Taxpayers also receive from the MLSC a certificate number which must be used on the return to claim the credit.

To the extent the credit exceeds the excise due, 90% of the excess may be refunded to the taxpayer. The credit may not be carried over to future years.

**Life Science Company Refundable Jobs Credit (M.G.L. c. 63, s. 38CC)** – A Certified Life Sciences Company, to the extent authorized by the Life Sciences Tax Incentive Program, may be allowed a refundable credit in an amount determined by the Massachusetts Life Sciences Center (MLSC). A taxpayer must commit to creating a minimum of 50 net new permanent full-time positions in the commonwealth to be eligible for the credit.

The MSLC will provide the taxpayer with a written authorization detailing the terms of any credit allowed (including the amount of credit) and the year in which the credit may be taken. Taxpayers also receive from the MLSC a certificate number which must be used on the return to claim the credit.

To the extent the credit exceeds the excise due, 90% of the excess may be refunded to the taxpayer. The credit may not be carried over to future years. **The credit is subject to recapture if the MLSC decertifies the company's status as a life sciences company.** See TIR 13-6, note 2.

**Refundable Dairy Credit (M.G.L. c. 63, § 38Z)** – Any taxpayer subject to tax under chapter 62 or a business corporation may be allowed a refundable credit based on the amount of milk produced and sold. The credit is non-transferable. The commissioner of agricultural resources, determines both eligibility for the credit and the amount of the credit for each taxpayer (the maximum total amount of the credits issued to all taxpayers may not exceed \$4,000,000 annually.) The commissioner of agricultural resources will issue each taxpayer a certificate number which must be used to claim the credit. To the extent the credit exceeds a taxpayer's liability, the excess is refundable. **The credit is not subject to recapture.**

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**Refundable Conservation Land Credit (M.G.L. c. 63, § 38AA)** – Any taxpayer subject to tax under chapter 62 or chapter 63 is allowed a credit equal to 50% of the fair market value of a qualified donation of certified land to a public or private conservation agency. The certification process is conducted by the Executive Office of Energy and Environmental Affairs (“EEA”). EEA has promulgated a regulation, 301 CMR 14.00, entitled Conservation Land Tax Credit, which sets forth criteria for authorizing and certifying the credit. The amount of the credit that may be claimed by a taxpayer for each qualified donation cannot exceed \$75,000 (\$50,000 for donations prior to August 13, 2014). The credit is refundable but not transferable. The total amount of credit allowed to all taxpayers may not exceed \$2,000,000. **The credit is not subject to recapture.**

Before the credit may be claimed, the taxpayer must obtain a qualified appraisal and must submit a summary (or the appraisal itself, if requested) to the Secretary of the EEA. The Secretary must certify that the Taxpayer made a qualified donation and will issue a certificate to the taxpayer that includes a certificate number (which must be used to claim the credit) and the amount of the credit. The valuation on which the credit is based is subject to audit by the Commissioner of Revenue. See [830 CMR 62.6.4](#).

To the extent the credit exceeds the taxpayer’s liability, the excess is refundable.

**Refundable Community Investment Credit (M.G.L. c. 63, s 38EE)** – A community investment tax credit is allowed to chapter 62 or chapter 63 taxpayers that make qualified investments (certain cash contributions made to a community development corporation, community support organization or a community partnership fund).

A Taxpayer may apply to the Department of Housing and Community Development (“DHCD”) for a certificate that entitles the taxpayer to a credit against its tax with respect to the taxpayer’s “qualified investment” (defined as a cash contribution to a specific community partner to support the implementation of its community investment plan or to a community partnership fund, as defined by section 38EE). The credit allowed is equal to 50% of the qualified investment. Taxpayers may make multiple investments in the same year but the maximum amount of credit that may be claimed by a taxpayer in any 1 taxable year is \$1,000,000.

Credits awarded to a pass-through entity such as a partnership or a limited liability company taxed as a partnership shall be passed through and may be allocated pro rata or under an executed agreement among the partners/members/owners documenting an alternative distribution method without regard to their sharing of other tax or economic attributes of the entity. See [830 CMR 62.6M.1](#) for procedures applicable in claiming the credit.

Corporations may take the credit in the year the qualified investment is made, and any amount in excess of the tax due is refundable. Alternately, at the taxpayer’s option, any credits not used may be carried forward for up to 5 taxable years. **The community investment credit is not subject to recapture and is not transferable.**

The Department of Housing and Community Development and the Department of Revenue have issued regulations and procedures to implement the credit. See 760 CMR 68.00, *Community Investment Grant and Tax Credit Program* and 830 CMR 62.6M.1 *Community Investment Tax Credit*.

The following table summarizes the limits on the credits discussed:

<b>Type of Credit</b>	<b>Ch. 63 Section</b>	<b>Credit Limitation</b>	<b>Credit Carryover</b>	<b>Transferable?</b>	<b>Special Provisions</b>
EDIP Credit Certificate # Issued by EACC	§ 38N	50% of excise, Not below \$456	10 years	c. 62 or c. 63	Refundable if EACC Authorized
EOA Credit (EOAC) Schedule EOAC with the Return	§ 38N	50% of excise, Not below \$456	10 years	c. 62 or c. 63	
Investment Tax Credit (ITC) Schedule H with the Return	§ 31A	50% of excise, Not below \$456	3 years	---	Mfg./R&D Corporations or be in Agriculture / commercial fishing
Vanpool Credit Schedule VP with the Return	§ 31E	50% of excise, Not below \$456	only per MGL §32C	---	Business Corps/S Corp only Reduce Basis for Depreciation
Research Credit Schedule RC with the Return	§ 38M	75% over \$25,000, Not below \$456	15 years	---	Business Corps/S Corp only Refundable if MLSC Authorized Reduce deduction by credit amt
Harbor Maintenance Credit Schedule HM with the Return	§ 38P	Not below \$456	5 years	---	Business Corps/S Corps only
Brownfields Credit Certificate # Issued by DOR	§ 38Q	50% of excise, Not below \$456	5 years	Yes	
Low Income Housing Certificate # Issued by DHCD	§ 31H	Not below \$456	5 years	Yes	
Historic Rehabilitation Certificate # Issued by MAHistCom	§ 38R	Not below \$456	5 years	Yes	

Film Incentive Credit Certificate # Issued by DOR	§ 38T	Not below \$456 unless refundable	5 years	Yes	Refundable @ 90% (limited)
Medical Device Credit Certificate # Issued by DOR	§ 31L	Not below \$456	5 years	Yes	
Employer Wellness Credit Certificate # Issued by DPH	§ 38FF	Not below \$456	5 years		Maximum credit \$10,000
Certified Housing Development Certificate # Issued by DHCD	§ 38BB	Not refundable	5 years	Yes	
Life Sciences ITC Certificate # Issued by MLSC	§ 38U	Not below \$456 unless refundable			Refundable @ 90% if authorized
Life Sciences R&D Credit Certificate # Issued by MLSC	§ 38W	75% over \$25,000, Not below \$456			Reduce deduction by credit amt
Life Sciences FDA User Fees Credit Certificate # Issued by MLSC	§ 31M				Refundable @ 90% if authorized Reduce deduction by credit amt
Life Sciences Jobs Credit Certificate # Issued by MLSC	§ 38CC				Refundable @ 90% if authorized
Dairy Credit Certificate # Issued by ComAgRes	§ 38Z			c. 62 or c. 63	Refundable @ 100%
Conservation Land Credit Certificate # Issued by EOEEA	§ 38AA			c. 62 or c. 63	Refundable @ 100%
Community Investment Credit Certificate # Issued by DHCD	§ 38EE		5 years	c. 62 or c. 63	Refundable @ 100%

Taxpayers with more credits available than they can use are allowed to choose which of several available credits to apply. As noted, some of the credits are transferrable, but otherwise credits belong to the corporation that earns them. If that corporation ceases to exist, its credits cease to exist. This rule includes mergers where the surviving corporation continues the business of both predecessors. Only credits belonging to the corporate entity that survives continue, and the credits of the corporation absorbed in the merger are lost.

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### 9.8.2 Recapture Taxes

Certain credits, by explicit statutory reference, are subject to recapture. The conditions that trigger the obligation to recapture and the amount of the tax benefit that must be paid back are outlined in the statute authorizing the particular credit. Most, but not all, recapture provisions are based on the idea that a tax benefit is given immediately with the expectation that the taxpayer will continue to qualify for the credit for a period of time; if the taxpayer ceases to qualify before the time is complete, the amount of the benefit is reduced proportionately. The recapture provision for ITC that is found at ([M.G.L. c. 63, § 31A\(e\)](#)) is the most commonly applied and is invoked by reference in several other credit statutes:

(e) With respect to property which is disposed of or ceases to be in qualified use prior to the end of the taxable year in which the credit is to be taken, the amount of the credit shall be that portion of the credit provided for in paragraph (a) which represents the ratio which the months of qualified use bear to the months of useful life. If property on which credit has been taken is disposed of or ceases to be in qualified use prior to the end of its useful life, the difference between the credit taken and the credit allowed for actual use must be added back as additional taxes due in the year of disposition; provided, however, if such property is disposed of or ceases to be in qualified use after it has been in qualified use for more than twelve consecutive years, it shall not be necessary to add back the credit, as provided in this paragraph. The amount of credit allowed for actual use shall be determined by multiplying the original credit by the ratio which the months of qualified use bear to the months of useful life. For the purposes of this paragraph, useful life of property shall be the same as that used by the corporation for depreciation purposes when computing federal income tax liability.

The phrase “is disposed of or ceases to be in qualified use prior to the end of its useful life” means that all of the requirements that apply for the credit to be given in the first place must be met throughout the entire useful life of the property. If the asset is sold or destroyed, it is no longer used by the corporation and no longer qualifies for the credit with respect to that asset. If the corporation ceases to use the asset in Massachusetts (e.g. it transfers the asset to another state), it no longer qualifies for the credit with respect to that asset. If the corporation ceases to be eligible to claim the credit (e.g. it disposes of its manufacturing operations), all property of the corporation ceases to be in qualified use at that time. Note that the first sentence of this paragraph applies the same test to an asset in the year in which it is purchased. Thus it is possible for a taxpayer to get some credit for an asset placed in service in March and scrapped in November.

“The amount of credit allowed for actual use” is the amount not subject to recapture. It is calculated for each asset based on the date that asset was placed in service and the date that asset ceased to be in qualified use (for convenience the end of the month is frequently

substituted, but a corporation that ceases to qualify for the credit determines the date/month in which that occurs and does not use the end of that taxable year). The table below shows the calculations for a manufacturing corporation that disposed of one asset in April of 2015 and ceased to be eligible for treatment as a manufacturing corporation in September of the same year (triggering recapture on all assets for which the credit had been claimed even though it still owned and continued to use the assets.)

Date Asset was placed in Service	Date no longer in Qualified Service	# Months Qualified Use	Tax Life (Months)	Original credit		Prorate by Months	Credit Allowed for Actual Use	Reduction in the Credit or "Recapture Amount"
01/15/2010	04/21/2015	51	60	\$300	X	51	= \$255	\$45
						60		
09/30/2012	09/30/2015	36	180	\$15,000	X	36	= \$3,000	\$12,000
						180		
01/11/2014	09/30/2015	21	60	\$500	X	21	= \$175	\$325
						60		

The reduction in the credit shown in the above table is added to the corporation's tax for the year of recapture only to the extent it was previously used to reduce tax. There is no recapture if the credit was never used. There is a reduction in the credit originally allowed for the 2010 tax year. If any of the ITC generated in the 2010 taxable year was not taken against excise (either by the corporation generating the credit or by an affiliate under the combined reporting rules) this \$45 reduction is first offset by unused credits (which are eliminated from any carryover) and only the amount actually taken becomes "recapture tax". See [DD 89-7](#).

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### **EDIPC and EOAC Recapture**

These credits are also subject to recapture if the asset for which the credit was granted ceases to be in qualified use before the end of its useful life. M.G.L. c. 63, § 38N(a) provides that recapture is done under the ITC rules and the mechanics of the transaction are identical. Where all of a manufacturing corporation's ITC assets cease to be in qualified use, they are subject to recapture if the corporation ceases to qualify as a manufacturing corporation. Similarly, taxpayers that have taken EDIPC and EOAC are subject to recapture if the project in which they are participating is "decertified" by the EACC.

The regulation applicable to the EOAC includes a provision explicitly endorsing the eligibility of a manufacturing corporation that was participating in such a project and took the EOA credit with respect to assets that otherwise would have been eligible for the ITC. Such corporations are

eligible to recalculate their credits and carryovers as if they had taken ITC in the first place. See [830 CMR 63.38.1\(11\)\(d\)](#). The logic on which this subparagraph is based applies equally to the EDIPC, and may well apply to other credits where ITC was not taken because of a prohibition on taking the section 31A credit if another credit was being allowed for the same assets. See [TIR 13-6, example 9](#).

### **Vanpool Credit Recapture**

Vanpool Credit recapture is required if the vehicle ceases to be in qualified use as a company shuttle van until the end of its useful life. The terms are the same (months of qualified use / months of useful life), but no recapture is required if the van has been in use for more than 4 consecutive years (instead of 12 years).

### **Brownfields Credit Recapture**

The Brownfields credit is subject to recapture if the taxpayer fails to maintain the remedy for the useful life of the property. The calculation of the reduced credit (the amount not subject to recapture) is again based on the number of months the taxpayer met the terms for the credit divided by the useful life of the property. Significantly, real property not subject to depreciation is assigned a useful life of 12 months for this purpose.

### **Low Income Housing Credit Recapture**

The LIHC is subject to recapture if the federal credit allowed for the same project is subject to recapture. If this occurs, the percentage of the Massachusetts credit reduction is the same as the percentage of the federal credit reduction.

### **Historic Rehabilitation Credit Recapture**

The HRC is subject to recapture if the taxpayer disposes of its ownership interest in the property within 5 years of the date when it becomes a completed project. The credit recapture amount is the credit taken or transferred by the taxpayer minus the credit allowed for ownership. The credit allowed is calculated using a ratio of the number of months the taxpayer owned the property after completion divided by 60 months. If the taxpayer sells or transfers only part of its interest in the property, recapture is required but is calculated using only a proportionate share of the credit. See [830 CMR 63.38R.1\(12\)\(e\) Example 3](#).

### **Life Sciences Credit Recapture**

The various life sciences credits are subject to recapture if the Massachusetts Life Sciences Center (MLSC) revokes the corporation's certification as a Life Sciences Company. See [TIR 13-6](#). Note that to the extent that a refundable credit was allowed by the MLSC and the taxpayer either (a) received a refund or (b) applied the refundable credit to reduce its excise below the amount that would have otherwise been allowed, recapture tax is required and may not be offset in the year it is added to excise by non-refundable credits (see footnote #2 of TIR 13-6.)

The Life Sciences ITC recapture is similar to the ITC recapture and the EDIPC/EAOC recapture, in that it is based on the number of months of qualified use and the life of the asset, and the assets all cease to be in qualified use on the effective date of the decertification (Life Sciences ITC may also be subject to recapture if the asset is sold, even if the taxpayer retains its status as a Life Sciences Company). Any recapture tax is due in the year the asset ceases to be in qualified

service. The taxpayer, if a manufacturing corporation, may be eligible to recalculate as if it had taken the general (§31A(e)) ITC on any assets previously excluded from the calculation because they were being considered for the Life Sciences ITC. See Example #9 at the end of TIR 13-6. The Life Sciences Refundable Research Credit may be granted for a commitment to create and maintain a certain number of jobs for a specified period. If the MLSC revokes the taxpayer's status as a Life Sciences Company, the recapture is done in the year of the revocation, but the amount to be recaptured is determined based on the number of months the taxpayer was in compliance with the terms of the jobs commitment divided by the total period of the jobs commitment. See Examples #3 and #4 in TIR 13-6.

The Life Sciences Refundable Jobs Credit is handled in a manner similar to the Life Sciences Refundable Research Credit if the taxpayer's status as a Life Sciences Company is revoked. Recapture is required in the year of revocation and the amount is based on the months the taxpayer met the commitment. See TIR 13-6, footnote #1.

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### 9.8.3 Tracing Credit Carryovers

Taxpayers claiming on a return a credit carryover from a prior year (whether or not the credit is being taken in the current year), must provide the auditor with a schedule showing the amount of credit originating and the amount used in each taxable year. Taxpayers may only carry forward credits to the extent they exceed the amount that can be used in the current year.

The table below is an example of a carryover schedule. It shows the credits taken in each year and the amount still available. The total generated can be checked against the credit schedules for these years. The total used can be checked against the tax calculation for the year. Note that this is only one form of the schedule – taxpayers are free to use any form of this information that works for them. Taxpayers may sometimes use the carryforward schedules included with schedule H, RC or EAOC.

Source Year	Credit Generated	Used in 2010	Used in 2011	Used in 2012	Used in 2013	Used in 2014	Used in 2015	Available for 2016
2010	7,000	5,000	2,000					0
2011	9,000		2,000	4,500	2,500			0
2012	4,000			0	4,000			0
2013	5,000				1,500	3,500		0
2014	42,000					3,000	3,000	36,000
2015	2,000						0	2,000
	Total Used	5,000	4,000	4,500	8,000	6,500	3,000	

In tracing the carryover, the auditor will verify that:

- (a) The taxpayer has reduced balances from year to year to reflect the amounts used and has adjusted the credit available to reflect the expiration period on certain credits. In the example above, this has been done.
- (b) There are no unusual spikes in the credit that are inconsistent with what is known about the history of the taxpayer's business. A spike may indicate that

controls in effect during the current year were not in effect in the prior year and may suggest additional investigation is required. In the example above, the credit for 2014 is unusual and some preliminary questions may resolve the issue or trigger an IDR.

- (c) Any credits reflected on the current year return belong to taxpayer. Credits may under certain circumstances be shared, but they are not transferrable in a reorganization. In the event of a merger, credits owned by the corporation which survives the merger are preserved, but credits owned by corporations absorbed in the merger are lost.
- (d) If there has been a federal change, the auditor must ensure that the taxpayer provides a revised schedule reflecting the changes to the carryovers as a result of the federal audit.

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#### 9.8.4 Adjusting Carryovers

Taxpayers seeking to take a deduction or a credit with respect to activity occurring in a prior year are subject to audit with respect to such a credit or deduction when they attempt to take it in the current year. This rule applies even though the prior year may be closed to assessment.

The carryover or credit need not be accepted at the value shown on the return. The taxpayer may be required to prove that the carryover or credit was properly calculated and potentially to trace it through a series of intermediate tax years before applying it in the current year. Auditors may question these calculations and the taxpayer's treatment of certain transactions in the same manner they question transactions relating to the returns in the period for which they are determining the correct amount of tax. Errors found in the later period may form the basis of document requests and or adjustments in the periods generating the claimed carry forward.

##### Example 1:

First Street Corporation is being audited for the year ending 06/30/2015. During the course of the audit it is discovered that the taxpayer failed to exclude wages paid to engineers in a Nashua, NH office when calculating the Research Credit. The taxpayer claims a Research Credit carry forward from 06/30/2014 on its schedule RC. The auditor determines that the Nashua office was opened in 2003. Work papers provided by the taxpayer show that it has already used all of the research credits generated in prior years.

The prior year calculations for research credit were adjusted as shown below:

	Per Return	Adjustment	Per Audit
Qualified Research Expenses	1,500,000	(300,000)	1,200,000
Less Base Amount	900,000		900,000
Incremental QRE	<u>600,000</u>	(300,000)	<u>300,000</u>
Credit Generated (incremental QRE x 10%)	60,000	(30,000)	30,000

Credit Carryover from prior Years	0		0
Total Available Credit	<u>60,000</u>	(30,000)	<u>30,000</u>
Credit Utilized	20,000		20,000
Ending Credit for Carryover	40,000	(30,000)	10,000

The credit carryover available for use in the tax year under audit is reduced from \$40,000 to \$10,000.

**Example 2:**

Manufacturing Corp is being audited for FYE 12/31/15. Manufacturing Corp had Massachusetts Net Income of \$5,000,000 in the audit year and an apportionment percentage of 10%, giving it an income measure of excise of \$40,000 per the return. The non-income measure of excise was \$10,000, and it generated \$60,000 of ITC and claimed \$55,000 of ITC carry forward from FY04 and FY05. As filed, it had a tax liability after credits of \$25,000 with \$80,000 in unused credits carried forward to 2016.

The audit determines that the taxpayer failed to apply the throwback rule to sales of tangible property. By including throwback states its proper apportionment factor was increased to 40%. This increases the current year tax before credits by \$120,000 (to \$170,000), but increases the tax after credits by only half of this amount (from \$25,000 to \$85,000 after credits) because there are credits available to offset half of the additional income excise.

The auditor next reviews the 2014 return as filed in tracing the \$35,000 carryover. The auditor notes that the apportionment percentage is consistent with the 2015 return as filed. In 2014, the corporation's taxable net income was \$4,500,000 and the non-income measure of excise was \$10,000. A review of the taxpayer's operational history shows that the same states should have been thrown back in prior years in the same manner as the 2015 period. The taxpayer is asked for and produces a sales by state schedule for each year, and it is determined that the appropriate apportionment percentage for 2014 was also 40%. The amount available for carry forward is recalculated with the new apportionment percentage:

	Per Return	Adjustment	Per Audit
Taxable Net Income to be Apportioned	4,000,000		4,000,000
Massachusetts Apportionment	10%	+30%	40%
Income Apportioned to Massachusetts	400,000	1,200,000	1,600,000
Income Measure of Excise	32,000	96,000	128,000
Non-Income Measure of Excise	10,000		10,000

Total Excise before Credits	<u>42,000</u>	96,000	<u>138,000</u>
Credits Available including Carryover	76,000		76,000
Credit Utilized (50% Maximum)	21,000	48,000	69,000
Ending Credit for Carryover	55,000	(48,000)	7,000

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### 9.8.5 Credits Checklist

The following steps should be taken as a starting point in verifying carry forwards (Auditors are required to follow-up as appropriate):

- ✓ Review taxpayer's workpapers tracing credit carry-forwards. Compare these with the results of any prior DOR audit of the taxpayer that addressed the credit.
- ✓ Verify that taxpayer correctly calculated credit amounts in each year based on the un-audited information (this is the absolute minimum required audit activity). For example:
  - were the amounts shown on the workpapers equal to the amounts shown on the returns?
  - did taxpayer fail to include base amount when calculating research credit?
- ✓ Investigate abnormal results (e.g. an increase or decrease in qualified research expenses or eligible ITC assets in one year during the carryover period or a significant change in the amount of credit used from one year to the next).
- ✓ Investigate current audit results that are inconsistent with audit findings in prior cycles.
- ✓ When a current audit determines a substantial error has been made, the auditor should evaluate the likelihood that the same error in prior years will generate tax attribute carry forwards.
- ✓ If it is likely the same error was made in prior years and the effect is significant, taxpayers should be asked to determine whether or not the same error did occur and document any relevant facts.
- ✓ If significant adjustment is indicated, recalculation should be performed even if the net effect on the current audit year is minimal.
- ✓ When the audit is complete, workpapers provided to the taxpayer should include those relative to determining the proper amount of carry forward available at the end of the audited period(s). If a new audit occurs for later periods, such workpapers will allow the auditor to rely on the prior year figures.
- ✓ If the carry forward at the end of the audit period has been significantly reduced, the auditor should review the following year to determine if the reduction has a significant tax impact. If the taxpayer is unwilling to file an amended return for the subsequent year, this should be a factor in determining whether or not to open an audit of the subsequent cycle.
- ✓ If during a subsequent audit a significant issue surfaces that actually went unnoticed in the prior period, the auditor should discuss it with the supervisor or manager.
- ✓

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## 9.9 Auditing S Corporations

Reserved

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## 9.10 Auditing Security Corporations

A security corporation must meet both the form and substance requirements of the statute ([M.G.L. c. 63, § 38B](#)). In reviewing a security corporation return, the auditor is expected to review DOR records with respect to the taxpayer's application for classification. A taxpayer that seeks to be classified as a security corporation must file an application before the end of the year in which it first seeks to be so classified and will receive a letter confirming that it has been so classified as of a certain date. If the taxpayer has never sought classification, it cannot be taxed as a security corporation. If the auditor is unable to produce a record of classification, the taxpayer should be asked to document that it has been so classified by producing a copy of that letter. Taxpayers may *not* substitute the filing of a return (Form 355SC) for formal classification (which is statutory), nor may they retroactively cure a failure to apply for classification.

Classification, once granted, is valid until revoked. It may be revoked retroactively by the Department if the taxpayer fails to comply with the limitations on activity in the statute or it may be revoked prospectively by a written request from the taxpayer. In reviewing a security corporation's return, the auditor may choose to require the taxpayer to demonstrate they are in compliance with the limitations in § 38B. For a very large security corporation this may be almost automatic, for others indications of non-compliance on the balance sheet or federal income tax return include (a) loans or receivables on the balance sheet (b) substantial tangible property owned, (c) significant business expenses inconsistent with a business of holding securities for the taxpayer's own benefit, and (d) evidence of intercompany transactions through a review of federal consolidation statements.

A request for further information should include a request for a list of the specific assets owned during the audit period (not just on the last day of the year) and detail on the sources of income reported on the return in addition to information about any item from the preliminary review that suggests the taxpayer engaged in activity outside the bounds of section 38B. Securities are defined by the statute as:

- (1) Equity or debt instruments and options, futures and other derivatives, traded on and acquired through a public exchange or other arm's length secondary market.
- (2) Bonds as defined in and issued pursuant to [Chapter 23G](#).
- (3) Cash and cash equivalents and among the included are savings and checking accounts, certificates of deposit and foreign currencies.
- (4) Interests in a Real Estate Investment Trust (REIT) or a Regulated Investment Company (RIC) or a Real Estate Mortgage Investment Conduit (REMIC) so long as none of the mortgages owned by the conduit were originated by the holder thereof or by an affiliate of the holder
- (5) Mortgage-backed securities that are guaranteed by FNMA, GNMA, FHLB or FHLMC.
- (6) Collateralized mortgage obligations, so long as none of the mortgages that underlie the obligation were originated by the holder thereof or by an affiliate of the holder; and
- (7) Any other passive investment vehicles that, in the judgment of the commissioner, shall be considered to constitute securities.

An Ownership interest in a REIT that is related member, as defined in M.G.L. c. 63, s. 31I is not considered a security for the purposes of s. 38B.

If the taxpayer is found to be improperly classified, the auditor must ensure that a subsequent assessment properly credits the tax paid as a security corporation. The method used may vary from case to case.

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# APPENDIX

## Initial IDR – Corporate Excise Field Audit

Date of Request:  
Case #:  
Federal I.D. #:  
Tax Period Ending:  
IDR #: 1

### Mandatory IDR – Corporate Field Audit

Provide the following within 30 days of this request. If a specific request is not applicable to the taxpayer for these years, provide a brief explanation (e.g., there may be no stockholder owning more than 50% of the voting stock for item #4, etc.). Electronic submission of the requested information is encouraged.

- 1) Provide copies of financial statements (audited financial statements, if available) for the audit period including any auditor's report and all applicable notes and disclosures.
- 2) Provide list of all Massachusetts Corporate (MGL c. 63) Tax Returns filed for the audit period by the taxpayer or, where applicable, by any member of a federal consolidated return. Please also provide copies of these returns.
- 3) Provide the names and addresses of stockholders owning, directly or indirectly, more than 50% of the corporation's voting stock (more than 50% of the common parent's voting stock if a taxpayer participates in filing a federal consolidated return).
- 4) Provide a list and detail of all known changes to the federal income tax returns as filed and/or the Massachusetts corporate tax returns as filed including I.R.S or other state's audit changes.
- 5) Provide a chart of accounts including relevant documentation (e.g. a description of accounts and/or subaccounts, a list of divisions or other units used to segregate expenses, etc.)
- 6) Provide a trial balance summary for each year (for each corporation included in the federal return, if applicable). Provide this in excel if possible. Also provide a grouping of accounts as they are combined or mapped for the federal income tax return.
- 7) Provide copies of workpapers showing the calculation of any book to tax adjustments for federal income tax purposes.
- 8) Provide copies of workpapers showing the detail of all Federal to Massachusetts adjustments to income or deductions.
- 9) Identify and, if applicable, provide a description of any cash management system, intercompany loan facility, intercompany sale of receivables and/or similar arrangement with related parties in effect for the audit period (whether or not those related parties all file a Massachusetts combined report).

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## **Administrative Summons – Supplemental Guidance to FAPM Chapter 6**

An Administrative Summons is an enforceable demand for the taxpayer to produce records and/or testimony. It is issued under the authority granted to the Commissioner under M.G.L. c. 62C § 70.

If an auditor encounters difficulty in obtaining books, records, documents or other information essential to the completion of the audit, an administrative summons may be issued. In almost all cases, the summons will be preceded by an IDR for the same records. For good cause, the auditor, after consulting with the supervisor/manager, may agree to extend the IDR response date provided it is likely to result in the documents being provided and the extension will not compromise the audit if the information is not produced at the extended response date. Good cause does not normally include a disagreement over whether or not the records are germane to the audit or whether or not the records are confidential. Where the taxpayer does not provide a complete IDR response by the due date, the auditor will attempt to determine the reason for the taxpayer's refusal and may (depending on the circumstances) pursue a summons to obtain responses to the IDR request(s).

If a summons is not to be immediately pursued, the auditor will send a follow-up letter to the taxpayer that specifically identifies the missing or incomplete items and addresses or disposes of any issues raised by the taxpayer with respect to the IDR request(s). The follow-up letter will specify a response date. The response date will generally be no more than 15 days from the date of the follow-up letter (exceptions require Director level approval). If the taxpayer has still not responded to the IDR requests, the auditor, with supervisory approval, can make a request for issuance of an Administrative Summons:

- If a summons is to be requested, the auditor will complete a request for Administrative Summons (this is in the form of a memorandum and the template is available in the Audit Forms section on DORNET).
- The request should include a concise explanation and description of what records the auditor is seeking and why the records are necessary, together with a summary of the efforts made to obtain the records and any response that may have been received by the taxpayer. All items on the request form must be completed, including the name of the individual to who the summons should be issued.
- Documents may be summonsed from a 3<sup>rd</sup> party. If this is the case, the circumstances should be explained in the request.
- This request, together with a copy of the IDR and any other subsequent correspondence related to the missing documentation (including the follow-up letter if one was issued) and a copy of the audit log are to be forwarded to the Bureau Chief with a copy to the Director (the auditor should review the complete request with their supervisor prior to forwarding).
- The Bureau Chief will forward the request to the Chief of Litigation or his/her designee. Any follow-up questions related to the summons will be directed to the auditor.
- Once approved, the summons will be drafted and signed by the Chief of Litigation or his/her designee. They will serve the summons either by certified mail or by constable (a copy of the summons will also be mailed to the taxpayer's statutory agent for service of process in MA).

The auditor should review the documents produced in response to the summons upon receipt and notify the Bureau Chief as soon as possible. In the event some or all of the documents requested are not provided in response to a summons, the auditor and the supervisor/manager should notify the bureau chief in writing and provide copies of any correspondence or notes of any conversations that may have occurred with respect to the summons or any of the documents requested in the summons. When applicable, a request for enforcement (there is an Enforcement Request on DORNET) will be routed to Litigation through the Bureau Chief.

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## IDR Control Sheet

IDR Control Sheet						
CORPORATION NAME:		0				
CASE#:		0				
IDR #	IDR Date	Item #	Description	Date Received	Date Review Completed	Comments
1		1	Copies of financial statements			
1		2	Copies of federal returns with all statements/schedules			
1		3	List and Provide Copies of Massachusetts returns			
1		4	Does any person or entity own more than 50%?			
1		5	List of Known Changes to the Tax Returns as filed			
1		6	Chart of Accounts & Documentation (Descriptions)			
1		7	Trial Balance Summary and Grouping of Accounts			
1		8	Federal Return Workpapers			
1		9	Fed to Massachusetts Income Adjustment Workpapers			
1		10	Cash Management System			

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**IDR LETTER - SUGGESTED FORMAT**

Taxpayer Contact  
TAXPAYER CORPORATION  
Address  
Address

Re: TAXPAYER CORPORATION - IDR # [ ] Dated July 8, 20xx

Dear Taxpayer Contact,

As we recently discussed, please provide responses to the following requests relating to TAXPAYER CORPORATION's cash management arrangement (CMA) inter-company annual balance amounts from 2005 through 2010:

- 1) Please provide a breakdown of the CMA intercompany balances on the books of the holding company (TAXPAYER HOLDING CORPORATION) for 2005 through 2010, including but not limited to the following:
  - a. Please explain and/or document the basis for the dramatic swings in inter-company balance amounts from year to year from 2005 through 2010;
  - b. Please verify whether these balances were strictly related to cash transfers under the CMA and, if not, please explain to what such transfers relate;
  - c. To the extent they are unrelated transfers kindly reconcile the differences in relation to the CMA.

Please provide your responses to these requests within thirty (30) days (on or before August 8, 20xx). If this timeframe is not possible please contact me so that we may discuss a timetable for completion.

Please let me know if you have questions or concerns or wish to further discuss these requests.

Thank you once again for your continued assistance in processing this audit.

Very truly yours,

Auditor

Enclosures

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## **SAMPLE IDR FOR RELATED MEMBER INTEREST EXPENSE**

Review of your tax return for the period ended \_\_\_\_\_ indicates you claimed one or more of Schedule ABI Exception 1 *Full Exception for interest paid, accrued, or incurred to a related member that is taxed at a similar rate* and Exception 3 *Business Purpose/Economic Substance or Foreign Treaty exceptions from the add back of interest expenses*. Add-back of such interest expense(s) shall not be required where the taxpayer establishes by clear and convincing evidence that add-back would be unreasonable. Please provide separate responses to the following requests to verify your claimed exception(s) (if a request is not applicable please indicate):

### **For Each Exception 1 Claim:**

- 1) A statement detailing the underlying transaction(s) generating the claimed interest deduction(s) including the entities involved, dates, amounts, terms and interest rate(s), loan activity and whether the interest paid, incurred or accrued relates to acquisition debt.
- 2) Tax return(s) of all other states, U.S. Possessions or foreign jurisdictions (as translated) or any combination thereof demonstrating reporting of corresponding interest income by related member(s).

### **For Each Exception 3 Claim:**

- 3) A taxpayer must provide a supporting statement as required under the add-back regulation (830 CMR 63.31.1). Please provide your Exception 3 supporting statement(s) and any schedules, calculations, worksheets or other documentation used to prepare such statements. If the claim relates to a foreign treaty, the additional information requirements of 830 CMR 63.31.1(5) must also be addressed.
- 4) If the corresponding interest income is exempt from foreign income reporting, provide the applicable foreign treaty claimed noting which provision(s) support a foreign treaty exception, as well as a complete foreign jurisdiction tax return (as translated) to which such foreign treaty exception relates.

### **For All Exception 1 and Exception 3 Claims:**

- 5) Complete U.S. Form 1120 as filed (including all schedules and supporting statements) and all amendments along with all IRS audit results or IRS audit status summary for the above listed tax year.
- 6) Worldwide organization chart of overall business structure including taxpayer and related members.
- 7) Name and EIN of related member(s) receiving interest expenses or costs paid, accrued, or incurred.
- 8) Loan agreements or other similar instruments, loan amortization and repayment history (including proof of repayment and documentation supporting source of funds) and all supporting documentation.
- 9) If related to cash management system(s) (CMS) provide all cash management agreements or other similar documents, listing of all CMS members and a detailed description of how each CMS operates.

Please submit the requested information within **30 days** from the date of this notice (electronic submission of responses is encouraged). If you fail to respond the Commissioner may deny your claimed exceptions and determine the tax, penalties and interest due according to best information available. Additional information may be requested. Please feel free to contact me if you have any questions.

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## **SAMPLE IDR FOR RELATED MEMBER INTANGIBLE EXPENSE**

Review of your tax return for the period ended \_\_\_\_\_ indicates you claimed one or more Schedule ABIE Exception 1 *Full Exception for direct or indirect intangible expense or cost paid, accrued, or incurred to a related member that is taxed at a similar rate* and Exception 3 *Business Purpose/Economic Substance, Foreign Treaty or Conduit exceptions from the add back of intangibles expenses*. Add-back of such expense(s) or cost(s) shall not be required where the taxpayer establishes by clear and convincing evidence that add-back would be unreasonable. Please provide responses to the following requests to verify your claimed exception(s) (if a request is not applicable please indicate):

### **For Each Exception 1 Claim:**

- 1) Statement detailing the underlying transaction(s) generating the claimed deduction, including original acquisition and use of the intangibles and how the related member ultimately received payments (i.e. describe all intermediate transactions among related/unrelated parties and payment differences).
- 2) Tax return(s) of all other states, U.S. Possessions or foreign jurisdictions (as translated) or any combination thereof demonstrating reporting of corresponding income by related member(s).

### **For Each Exception 3 Claim:**

- 3) A taxpayer must provide a supporting statement as required under the add-back regulation (830 CMR 63.31.1). Please provide your Exception 3 supporting statement(s) and any schedules, calculations, worksheets or other documentation used to prepare such statements. If the claim relates to a foreign treaty, the additional information requirements of 830 CMR 63.31.1(5) must also be addressed.
- 4) If the corresponding income is exempt from foreign income reporting, provide the applicable foreign treaty claimed noting which provision(s) support a foreign treaty exception, as well as a complete foreign jurisdiction tax return (as translated) to which such foreign treaty exception relates.

### **For All Exception 1 and Exception 3 Claims:**

- 5) Complete U.S. Form 1120 as filed (including all schedules and supporting statements) with all amendments along with all IRS audit results or IRS audit status summary for the above listed tax year.
  - 6) Worldwide organization chart of overall business structure including taxpayer and related members.
  - 7) All Intangible/royalty agreements or similar instruments and payment history (including proof of payment and documentation supporting source of funds).
  - 8) Name and EIN of related member(s) directly or indirectly receiving corresponding income.
- Please submit the requested information within **30 days** from the date of this notice (electronic submission of responses is encouraged). If you fail to respond the Commissioner may deny your claimed exceptions and determine the tax, penalties and interest due according to best information available. Additional information may be requested. Please feel free to contact me if you have any questions.

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**IDR for Mutual Fund Service Corporation**

**Date of Request:**

**Case #:**

**Federal I.D. #:**

**Tax Period Ending:**

**IDR #:**

**IDR – Mutual Fund Service Corporation**

- 1) Pursuant to 830 CMR 63.38.7(2), a “Mutual Fund Service Corporation” is defined as “any domestic or foreign corporation, corporate trust, or limited liability company doing business in Massachusetts, which separately derives more than 50% of gross income from providing, directly or indirectly, management, distribution or administration services to or on behalf of a regulated investment company, and from trustees, sponsors and participants of employee benefit plans which have accounts in a regulated investment company.”

Please provide a detailed explanation and supporting documentation that substantiates that \_\_\_\_\_ qualifies as a Mutual Fund Service Corporation.

- 2) Please provide supporting documentation relating to the underlying methodology for calculating MA apportionment for .....pursuant to 830 CMR 63.38.7. More specifically, please provide supporting documentation, for each audit period, demonstrating how the requisites steps outlined below were followed, calculated and/or determined under 830 CMR 63.38.7(4):

**Step 1. Determine taxable net income from mutual fund sales:**

- (i) Separate (i) mutual fund sales and (ii) non-mutual fund sales into respective categories;
- (ii) Separate allowable deductions into respective categories ((i) directly traceable to mutual fund sales, (ii) directly traceable to non-mutual fund sales and (iii) other allowable deductions);
- (iii) Taxable net income from mutual fund sales = Gross income derived from mutual fund sales less: (i) any deductions directly traceable to mutual fund sales and (ii) a portion of other allowable deductions, determined by multiplying the total amount of other allowable deductions by a fraction, the numerator of which is the mutual fund service corporation’s gross income derived from mutual fund sales for the taxable year, and the denominator of which is the mutual fund service corporation’s total gross income for the taxable year;

**Step 2. Determine sales factor:**

- (i) Separate mutual fund sales of each individual RIC;
- (ii) Multiply separate amounts of mutual fund sales for each RIC by a fraction representing the average number of shares owned by the RIC’s shareholders domiciled in Massachusetts over all of the RIC’s shareholders;
- (iii) Add resulting amounts to determine total mutual fund sales assigned to MA;
- (iv) Calculate sales factor by factoring total mutual fund sales assigned to MA over total mutual fund sales;

**Step 3. Apportion income from mutual fund sales to MA by multiplying the taxable net income**

from mutual fund sales by the calculated sales factor.

- 3) To the extent not already provided, please produce copies of all general ledger trial balances or other suitable records that identify the income-producing activities and the costs associated with them for each *mutual fund service corporation* pursuant to 830 CMR 63.38.7(6)(b).

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NEXUS QUESTIONNAIRE – Statements of Fact Relative to Business

Commonwealth of Massachusetts  
 Department of Revenue  
 200 Arlington Street  
 Chelsea, MA 02150

Auditor Name:

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1. Name of Corporation FID #  
 1a. Name of Principal Reporting Corporation FID #

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2. Address of Principal Office

---

3. State of Incorporation 4. Date of Incorporation

---

5. Principal Business Activity

---

6. Have you ever filed returns with the Massachusetts Department of Revenue?

Type of Tax	Ever Filed? Yes/No	First Tax Period Filed	Last Tax Period Filed	ID# Used to file this tax	Exact name used to file the last tax return of this type
Sales/Use Tax					
Meals Tax					
Room Occupancy					
Withholding Tax					
Corporate Tax					
Motor Fuels Tax					

For any of the above taxes that were filed, provide the dates for which returns were filed, the ID# Used and the exact name use to file the last tax return that was filed for this tax type.

7a. Names and addresses of officers of the corporation, agents or contractors in Massachusetts.

7b. Provide a description of the activities of these officers, agents or contractors in Massachusetts.

8. Have you ever owned or rented any real and/or tangible personal property in Massachusetts? (Include inventory on consignment or in public warehouses) Yes \_\_\_\_\_ No \_\_\_\_\_

If the corporation has ever owned or rented real or tangible property in Massachusetts,

(a) state the value of property owned at original cost at the end of each taxable year for the last seven years.

If real and/or tangible personal property was rented, state the amount of annual rent paid.

Year Ended		Property Everywhere	Property in Massachusetts
	Cost of Tangible Property		
	Rent paid for Property		
	Cost of Tangible Property		
	Rent paid for Property		
	Cost of Tangible Property		
	Rent paid for Property		
	Cost of Tangible Property		
	Rent paid for Property		
	Cost of Tangible Property		
	Rent paid for Property		
	Cost of Tangible Property		
	Rent paid for Property		
	Cost of Tangible Property		
	Rent paid for Property		
	Cost of Tangible Property		
	Rent paid for Property		

If the corporation has ever owned or rented real or tangible property in Massachusetts, (b) show the date the corporation first acquired any items listed below:

(1) Land and /or buildings in Massachusetts: \_\_\_\_\_

- (2) Inventory in Massachusetts: \_\_\_\_\_
- (3) Other owned property in Massachusetts: \_\_\_\_\_
- (4) Rented property in Massachusetts: \_\_\_\_\_

c. With respect to each type of property listed below, state the location (address) in Massachusetts.

- (1) Land and / or buildings: \_\_\_\_\_
- (2) Inventory: \_\_\_\_\_
- (3) Other owned property: \_\_\_\_\_
- (4) Rented property: \_\_\_\_\_

9. Have you reported any income from the sale or licensing of intangibles such as patents, copyrights, trademarks or trade names on your Federal Income Tax Return during the last seven years?

Yes \_\_\_\_\_ No \_\_\_\_\_ If yes, how much income did you report?

Year Ended	Royalty Income	Name and Address of Licensee

10. Have you deducted any payments for the use of intangibles such as patents, copyrights, trademarks or trade names on your Federal Income Tax Return during the last seven years?

Yes \_\_\_\_\_ No \_\_\_\_\_ If yes, what was the total expense paid?

Year Ended	Royalty Expense	Name and Address of Licensor


11. Have you ever sold any tangible personal property to a purchaser located in Massachusetts?

Yes \_\_\_\_\_ No \_\_\_\_\_ If yes;

a. What was the date you first made sales of tangible personal property to a purchaser located in Massachusetts? \_\_\_\_\_

b. Do you have sales people who come into Massachusetts to solicit orders? Yes \_\_\_\_\_ No \_\_\_\_\_

c. Was any product shipped from a location in Massachusetts? Yes \_\_\_\_\_ No \_\_\_\_\_

12. If sales were delivered to a Massachusetts address, then, were any sales delivered:

(1) In vehicles driven by drivers employed by your company? Yes \_\_\_\_\_ No \_\_\_\_\_

(2) In vehicles owned by your company? Yes \_\_\_\_\_ No \_\_\_\_\_

(3) In Vehicles driven or owned by a related company? Yes \_\_\_\_\_ No \_\_\_\_\_

(4) By common carrier? Yes \_\_\_\_\_ No \_\_\_\_\_

Name/address of the common carrier(s) used:

a. If sales were delivered in vehicles driven or owned by your company, how many such deliveries were made in the last seven years?

Year Ended	How many sales were delivered to a Massachusetts address in vehicles driven or owned by your company in

b. State the amount of gross receipts reported on Line 1(c) of your Federal Income Tax Return for the last seven years from sales of tangible personal property?

Year Ended	Worldwide receipts from	Massachusetts receipts from

--	--	--

c. List names and addresses of your largest customers in Massachusetts.

- | <u>Name</u> | <u>Address</u> |
|-------------|----------------|
| A.          |                |
| B.          |                |
| C.          |                |
| D.          |                |
| E.          |                |

13. Does the corporation maintain an office, display, or sample room in Massachusetts?

Yes \_\_\_\_\_ No \_\_\_\_\_ If yes, list:

- A. Address of the building:
- B. Purpose of the building:
- C. Telephone #:

14. Is this corporation listed in any Massachusetts telephone directories?

Yes \_\_\_\_\_ No \_\_\_\_\_ If yes, list:

- A. Address of the building:
- B. Purpose of the building:
- C. Telephone #:

15. Have you employed any marketing programs which have compensated anyone in Massachusetts with cash or merchandise for facilitating sales during the past seven years?

Yes \_\_\_\_\_ No \_\_\_\_\_ If yes, please explain the nature of your marketing program.

16. Have any of your employees ever performed any type of service in Massachusetts (examples: training, installation, repair)?

Yes \_\_\_\_\_ No \_\_\_\_\_ If yes;

a. What was the date your first employee performed services in Massachusetts?

b. Please explain the nature of the service(s) performed.

c. Number of employees who have performed services in Massachusetts in the last seven years.

Year Ended	Number of employees who have performed services in Massachusetts in each of the last 7 years


d. List the amount of gross receipts from the sale of services reported on Line 1(c) of your Federal Income Tax Return for the last seven years.

Year Ended	Worldwide receipts from	Massachusetts receipts from

17. Gross receipts or sales reported on Line 1(c) of your Federal Income Tax Return for the last seven years.

Year Ended	Total gross receipts or sales from your Federal Income Tax Return

18. Net Income (before net operating loss and dividends deduction) reported on Line 28 of your Federal Income Tax Return for the last seven years.

Year Ended	Net Income from your Federal Income Tax Return

--	--

19. Names, addresses and social security numbers of the five highest paid employees who have performed some type of service (ex. sales, training, installation, repair) in Massachusetts during the most recent tax year.

- |    | <u>Name</u> | <u>Address</u> | <u>Social Security Number</u> |
|----|-------------|----------------|-------------------------------|
| A. |             |                |                               |
| B. |             |                |                               |
| C. |             |                |                               |
| D. |             |                |                               |
| E. |             |                |                               |

20. Attach a list showing the exact corporate names of all affiliated corporations and their FID #. For all affiliated corporations listed, submit a copy of this questionnaire to a responsible corporate officer and have him/her answer questions 1 through 18.

Under penalties of perjury, I, as a principal officer of the above named corporation, declare that the information furnished in this questionnaire is to the best of my knowledge and belief, true, correct and complete.

_____	_____	_____
Date	Signature of Officer	Title

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# Chapter 10

## Corporate Combined Reporting Audit Procedures

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## 10.0 Auditing the Corporate Combined Report

### **Massachusetts Corporation Excise**

Except as otherwise directed under [M.G.L. c. 63, § 68C](#), every business corporation organized in or exercising its charter in Massachusetts, doing business in or qualified to do business in Massachusetts, or owning or using any part or all of its capital, plant or other taxable property in Massachusetts, is generally subject to the Massachusetts corporate excise under [M.G.L. c. 63, § 39](#).

The Massachusetts corporate excise is imposed on a business corporation's net income (its "income measure") and on its tangible property or net worth (its "non-income measure") with a current minimum excise of \$456 if the computed excise is less than the minimum excise due. Generally a business corporation's net income for Massachusetts purposes is based on its federal gross income subject to certain modifications. [M.G.L. c. 63, § 30.4](#).

### **Massachusetts Corporate Combined Reporting**

In general, a business corporation subject to tax on its net income under [M.G.L. c. 63](#) that is engaged in a unitary business with one or more other corporations related by common ownership (together, a "combined group") is required to calculate its taxable net income from such unitary business as an apportioned share of the combined group's taxable income pursuant to [M.G.L. c. 63, § 32B](#). This applies to taxable years beginning on or after January 1, 2009.

This chapter on corporate combined reporting audit procedures is divided into sections covering suggested procedures to be followed by an auditor in the audit of a corporate combined report and the issues the auditor needs to address when completing the audit review. This chapter should be used in concert with the relevant parts of [Chapter 9](#) which apply to the procedures for auditing a single stand-alone business corporation or financial institution. Except as otherwise required by context, the procedures applicable to the audit of a single business corporation or financial institution continue to be applicable in the audit of a corporate combined report.

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## 10.1 Corporate Combined Reporting – Legal Authority

### **10.1.1 M.G.L. Chapter 63 Section 32B – The Combined Reporting Statute**

The effect of [M.G.L. c. 63, § 32B](#) and the regulations promulgated thereunder is to require a taxable corporation that is a member of a combined group engaged in a unitary business to calculate its taxable net income derived from such unitary business as its apportioned share of the group's income or loss, as determined in accordance with a combined report. This calculated taxable net income amount is used in place of the calculation that would otherwise have been used under Chapter 63 by a single stand-alone business corporation to determine its income measure of the corporate excise.

### **10.1.2 830 CMR 63.32B.2 – The Combined Reporting Regulation**

Detailed regulatory guidance with respect to Massachusetts combined reporting law is set forth at [830 CMR 63.32B.2, which](#) provides rules for the reporting of income required under [M.G.L. c. 63, § 32B](#) (the “combined reporting regulation”). Auditors should refer to and familiarize themselves with the combined reporting regulation in order to effectively conduct the audit of a corporate combined report.

**Example:** a number of terms related to combined reporting are specifically defined in subsection (2) of the combined reporting regulation. See [830 CMR 63.32B.2\(2\)](#). Auditors should refer to subsection (2) when additional information and understanding of specific combined reporting terminology is needed.

The combined reporting regulation applies to taxable years beginning on or after January 1, 2009. [830 CMR 63.32B.2\(14\)](#).

### **10.1.3 Effect of Combined Reporting on Other Legal Authority**

Auditors must be aware of what legal provisions are affected and are not affected by combined reporting. In general, unless it is directly expressed otherwise, there is nothing in the combined reporting regulation that auditors should construe as limiting or negating adjustments which are otherwise permitted under MA law, including adjustments under M.G.L. c. 63, §§ 31I, 31J or 31K (Add-back Provisions), M.G.L. c. 63, § 39A (Business Subsidiary Corporations), and M.G.L. c. 62C, § 3A (Sham Transactions and Related Doctrines). See [830 CMR 63.32B.2\(13\)](#).

#### **M.G.L. c. 63 Sections 31I, 31J or 31K (Add-back Provisions)**

The Add-back Provisions do not apply to transactions between corporations that are members of the same combined group to the extent such transactions are deferred or eliminated under the combined reporting rules. See [830 CMR 63.32B.2\(6\)\(c\)\(5.\)](#). Conversely, the auditor must verify that all inter-company transactions among members of the same combined group that have not been deferred or eliminated under the combined reporting rules have been addressed.

**Note:** If an affiliated group election has not been made (i.e., the default Water’s Edge rules apply or there is a Worldwide election), the Add-back provisions will apply as to the following combined reporting transactions:

- (1) transactions between a corporation that is a member of the combined group and a corporation that is not a member of the combined group (e.g., certain insurance companies, a security corporation, or certain non-U.S. corporations in the instance where a worldwide election has not been made);
- (2) transactions between corporations that, although under common ownership, are each a member of a separate combined group; or
- (3) transactions between corporations that are otherwise filing on a combined basis when the transaction does not relate to the unitary business.

See [830 CMR 63.32B.2\(13\)](#).

**M.G.L. c. 63, § 39A (Subsidiary Corporations); M.G.L. c. 62C, § 3A (Sham Transactions and Related Doctrines)**

In general, the provisions of [M.G.L. c. 63, § 39A](#) and [M.G.L. c. 62C, § 3A](#) apply to transactions that are otherwise governed by the combined reporting regulation. [830 CMR 63.32B.2\(13\)](#).

Therefore, auditors must still review transactions and business organizational structures under the light of these statutory provisions as warranted under the facts and circumstances of a particular audit.

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## 10.2 Overview of Corporate Combined Reporting

An overview of combined reporting highlights many of the differences and similarities between the audit of a single stand-alone business corporation and the audit of a corporate combined report.

The requirement of combined reporting is in recognition of the fact that a unitary business can be conducted not only through separate divisions of a single corporation but also through corporations related by common ownership. The requirement also recognizes that in the context of a multi-state “unitary” business it is proper and constitutionally permissible to apportion the resulting business income even if such income arises from activities conducted outside the state. The requirement of combined reporting is not dependent upon an evidentiary showing that there is a distortion of income between corporations that are related by common ownership, or that there is a lack of arm’s length pricing in transactions between such corporations. [830 CMR 63.32B.2\(1\)\(b\)](#).

### 10.2.1 The Combined Report - Form 355U and Computational Schedules

The combined report must be filed with the taxpayer’s tax return and must include the income and apportionment information of all corporations that are members of the combined group along with all other information and filings in the manner prescribed by the Commissioner. All members of the combined group that are taxable in Massachusetts must submit a schedule with the combined report showing their individual tax calculations.

#### **Filing of a Combined Report**

The combined report (Form 355U and schedules) is filed on behalf of the combined group by the Principal Reporting Corporation (PRC) which is designated by members of the group to act as agent for the combined group (for receiving notices, executing waivers, filing abatements, etc.). The PRC is usually a taxable member (as opposed to a non-taxable member) of the combined group. See [830 CMR 63.32B.2\(11\)](#). However, by virtue of [Directive 15-2: Approval of Principal Reporting Corporation](#), the commissioner has approved the designation of a member that is not an entity specifically designated by the regulation to perform as PRC and constitutes the commissioner’s written approval of a non-nexus PRC (i.e., a non-taxable member) of a combined group.

### **Combined Reporting - Notices, Agreements and Audit Assessments**

The Department of Revenue sends a notice of audit to the Principal Reporting Corporation as agent for all of the corporations that participated or were required to participate in a combined report filing. The Principal Reporting Corporation is also the agent for any non-taxable members that are paying tax through the combined filing (i.e., other than on income derived from the unitary business) and for corporations that are erroneously included in the combined filing. Agreements executed by the Principal Reporting Corporation (including waivers of the statute of limitations) are binding on all such corporations. For tax years beginning on or after January 1, 2011, where an audit results in changes to the excise for various group members, the commissioner will net audit increases and decreases and issue a single notice to the Principal Reporting Corporation (on its own behalf and as agent for each corporation being assessed) showing the aggregate total due to satisfy the administrative requirements of [M.G.L. c. 62C, s. 26\(b\)](#). In such cases, the commissioner must also make available audit work papers to the Principal Reporting Corporation showing additional detail on the changes to excise as they relate to each individual member. See [TIR 14-11](#). From the auditor's perspective, all audit work papers will be sent or otherwise made available to the Principal Reporting Corporation. The final audit work papers must include a schedule showing the net change to tax for each separate member of the combined group for which an audit change was made. The commissioner is not precluded from separately and directly assessing an individual corporation subject to tax under chapter 63 rather than assessing such corporation through the cumulative assessment procedure described above - even when such individual corporation participated in or was required to participate in a combined report.

**Note:** Auditors must remember that under Massachusetts law, the principal reporting corporation is merely the entity that serves as the agent of the members of a combined group with respect to the receipt of certain legal notices and the taking of certain specific actions as required by Massachusetts law. The selection or designation of principal reporting corporation does not represent or confer any legal status greater than as discussed above. For an illustrative example of this in the context of combined group elections, see [Combined Group Election – Effect of Merger or Acquisition](#) in [10.2.3 Corporate Combined Reporting - Group Election Options](#) below.

### **Form 355U and Required Computational Schedules**

A combined report under M.G.L. c. 63, § 32B is a computational schedule. For administrative purposes, it is filed as a Form 355U with a series of schedules which include the separate tax calculations of those members of the group that are taxable in Massachusetts. The following are required as part of a Form 355U combined report:

Form 355U shows the aggregate tax liability of the combined group, declares whether the combined group is making or filing pursuant to either a worldwide or affiliated group election, and provides other general information on behalf of the combined group and its members.

Schedules U-M are filed for the individual members showing each member's income and deductions (this is similar to the requirement that individual members of a federal consolidated group report their separate income and deductions). Schedule U-M provides amounts as reported for federal income tax purposes, adjustments removing federal carryovers and certain limitations imposed only in the final calculations, and any items excluded in the calculation of the group's combined income or loss. In the case of an

affiliated group election, there are no exclusions. In the case of a worldwide election, the schedule U-M filed for a non-US corporation will report all of its income and deductions and not just that portion that is US Source income under the Code.

Schedules U-CI report the consolidated incomes and deductions of the various members as reported on the various schedules U-M. Schedule U-CI is affected by combined group elections only to the extent it affects what is shown on schedule U-M.

Schedule U-E reports adjustments for Chapter 63 taxation and also reports the calculation of the shared denominators for apportionment factors, which will include only the factors applicable to the production of the income being included in the combined report. In the case of an affiliated group election, no factors will be excluded as being outside the unitary business. In the case of a worldwide election, the taxpayer will include any factors of non-US corporations applicable to the income reported, including those from non-US activities.

Schedules U-MSI are filed for members that are taxable on their income in Massachusetts. These schedules show the calculation of Massachusetts apportioned income for the various taxable members based on the statutory rules applicable to that member due to on its own activities and that member's property, payroll and sales in Massachusetts which relate to the combined group's unitary business. In the case of a worldwide election, sales of a non-US corporation that are applicable to what is not "US source income" (including sales of services or inventory property in Massachusetts) are included if the income is included in the combined report.

Schedules U-ST are completed by taxable members and (for years beginning in 2011) by members not subject to tax on their income but liable for the non-income measure of excise under M.G.L. c. 63 § 39. Individual taxable members use this schedule to show the calculation of their Chapter 63 excise. Each member's apportioned shares of income determined on schedule U-MSI is added to any income or loss they may have from sources other than the unitary business (including income or loss from a period in which they may not be unitary with the group) and federal netting required to effect the capital loss limitation in the Code are done at the level of each taxable corporation. Eligible members take or share NOL deductions and determine their income measure of tax using the tax rate applicable to the member for the year. Other taxes (a non-income measure of excise, recapture taxes, a minimum excise, etc.) are added. Credits are taken by individual members against their excise to the extent available and permitted by law.

Other schedules are included as required based on the circumstances of the group's business and any claim of deductions or exemptions.

### **The Non-Income Measure Component**

For tax years 2009 and 2010, members of the combined group that were subject to the non-income measure also filed a separate return to calculate and pay tax on the non-income measure of the excise. From the 2011 tax year forward, the non-income measure component is incorporated within the combined report. See [Department Directive Directive 11-5](#). In rare circumstances a taxable member's taxable year for federal income tax purposes may not end in the same month as the common year used to compute the income from the common business (e.g., the combined group computes income on a calendar year basis but one member has a

fiscal year ending in June). See “Fiscalization” ([830 CMR 63.32B.2 \(12\) \(c\)](#)). In such cases, such taxable member will be required to calculate and pay the non-income measure of the excise on its separately-filed return.

### **Administrative Provisions**

Members of a combined group must file tax returns consistent with the provisions of M.G.L. c. 63 and M.G.L. c. 62C and the relevant rules set forth in the combined reporting regulation ([830 CMR 63.32B.2](#)). The commissioner may issue additional administrative rules and guidance relating to the filing and contents of the combined report. See [830 CMR 63.32B.2\(12\)\(a\)](#). A principal reporting corporation acting on behalf of the other members of the combined group must use Form 355U, together with its supporting schedules, to report the tax due from each member of the combined group. Each member should use schedule U-ST to calculate its separately-determined Chapter 63 income and non-income measures of excise within the combined report to meet its filing requirements under [M.G.L. c. 62C §§ 11](#) and 12. The filing requirement for a member is met if Form 355U includes a completed schedule U-ST (and the completed schedules that form requires) for that member. A member for which no schedule U-ST has been filed is not considered to have met a filing requirement either as to the member’s separately-determined Chapter 63 income and non-income measures or as to that member’s apportioned share of the combined group’s taxable income. This is so in the latter instances even if the member’s income is included in the combined report more generally. Hence in any of these instances the member would be a non-filer with respect to its Massachusetts tax obligation(s).

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#### **10.2.2Combination under M.G.L. c. 63 Section 32B**

Combined reporting is required under [section 32B](#) whenever a corporation is (1) taxable on its net income in Massachusetts (i.e., has nexus), (2) engaged in a unitary business with one or more other corporations that are related by common ownership and (3) is the type of corporations that is subject to combined reporting and would be taxable on its net income if it were doing business in Massachusetts. [830 CMR 63.32B.2\(1\)\(b\)](#).

#### **(1) Corporation Taxable on its Net Income in Massachusetts (Nexus)**

Before a state may impose a tax there must be a sufficient minimal connection, or “nexus,” between the state and the person or entity it proposes to subject to tax. Also, a state may tax an out-of-state corporation on an apportionable share of its interstate business provided there is the requisite connection between such interstate activities and the taxing state. [General Mills, Inc. v. Commissioner](#), 440 Mass. 154, 161 (2003). The reason for this is to abide by the principles derived from the Commerce Clause and the Due Process Clause of the U.S. Constitution. *Id.* Once nexus is established, if a corporation does not have income from business activity which is taxable in another state the whole of its taxable net income shall be allocated to Massachusetts. However, a corporation that has income that is taxable in Massachusetts and is also subject to tax in another state is taxed in Massachusetts on an apportionable share of its interstate business. Thus, where a corporation is part of a unitary business related by common

ownership, the income measure of the corporate excise is based on an apportionable share of its unitary interstate business.

A combined report is required even if only *one* member of a unitary business related by common ownership has the requisite connection to Massachusetts, and must include as members all business corporations engaged in the unitary business related by common ownership, whether they have nexus or not, unless they are specifically excluded from membership under M.G.L. c. 63, § 32B. However, only members with nexus to Massachusetts are subject to the corporate excise in Massachusetts.

The auditor must undertake a nexus determination in the same manner for a separate stand-alone corporation and for each of the corporations engaged in a unitary business when performing an audit of a combined report. See section [9.5 Corporate Nexus](#). This is because nexus is a threshold requirement for both the imposition of the corporate excise and for the filing of a combined report, and continues to be determined from the perspective of each individual corporation, *not* from the perspective of the entire combined group. See section [10.4.3 Corporate Combined Reporting Group Nexus – Checklist](#).

## (2) Common Ownership and Unitary Business Standards

In addition to nexus, both the common ownership and unitary business requirements are foundational in determining whether one or more business corporations should be subject to combined reporting in Massachusetts.

Common Ownership Standard - The common ownership standard requires that more than 50% of the voting control of each member is directly or indirectly owned by a common owner or owners. It is not necessary that the owner be a member of the group (e.g., the standard is met if an individual owns 51% of the voting stock in each of 2 corporations). [830 CMR 63.32B.2\(2\)](#). See section [10.4.8 Common Ownership - Checklist and Examples](#).

Unitary Business Standard - The unitary business standard is not limited to circumstances involving sales between the members but can be based on a significant “flow of value” between the separate parts. By statute, [M.G.L. c. 63 § 32B](#) directs that this standard be interpreted to the broadest extent permitted under the Constitution of the United States. There are many state and federal cases which address the Constitutional limits of what can be considered a unitary business. See section [10.4.4 Unitary Business Standard – Tests for Unity](#).

## (3) Corporations Subject to Combination under Section 32B

Since not all corporations are subject to the requirement of combined reporting, the auditor must verify that the corporations in the combined group are indeed subject to combination. See section [10.4.1 Types of Corporations Subject to Combination under Section 32B - Checklist](#). This verification also requires a determination that the entity is not one of the types of corporations to which combined reporting does not apply, even if it is otherwise engaged in the unitary business. See [830 CMR 63.32B.2\(4\)\(b\)](#).

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### 10.2.3 Corporate Combined Reporting - Group Election Options

Massachusetts generally approaches combined reporting by applying default “water’s edge” filing rules to determine a taxpayer’s taxable net income as an apportioned share of the combined group’s taxable income. Alternatively, a taxpayer member of a combined group may make one of two available combined group elections which can modify the application of these default provisions: (1) an affiliated group election; or (2) a worldwide group election. Note: Auditors must keep in mind that the threshold requirements for filing a combined report apply and must be verified before the validity of (or consequences arising from) any combined group election is evaluated:

Example: two corporations that are not engaged in a unitary business cannot elect to be treated as an affiliated group so that they may share losses or convert allocable to apportionable income. Pursuant to c. 62C § 3A, the commissioner may disregard the tax effect of an affiliated group election where it appears it will not have a meaningful continuing application (see [830 CMR 63B.2\(10\)\(h\)](#)). Conversely, if the two corporations are required to file a combined report (and are otherwise eligible) they can elect to be treated as an affiliated group the consequence of which might be, among other things, to share losses or convert allocable to apportionable income.

#### **Default Rules-Water’s Edge Unitary Group (830 CMR 63.32B.2(5)(b))**

The statutory requirement to determine taxable net income as an apportioned share of the combined group’s taxable income is imposed by default on a “water’s edge” basis. [830 CMR 63B.2\(5\)\(b\)](#). Corporations incorporated in the United States, or formed under the laws of the United States, any state, the District of Columbia or in any territory or possession of the United States, are includible as a member of the water’s edge unitary group if they meet both the common control and unitary business requirements and are otherwise includible (see [10.2 Overview of Corporate Combined Reporting](#)). These corporations determine gross income and deductions on a worldwide basis under the Internal Revenue Code, and exclude income only if it is not part of the unitary business.

Foreign (non-US) corporations are not subject to combination in a “water’s edge” filing unless they (1) meet both the common control and unitary business standards and (2) any of the following of a) through c) apply:

- a) The non-U.S. corporation is itself taxable in Massachusetts (note that such corporations, as included within the combined report, will then use c. 63 § 32B to determine their taxable net income). As an example, the licensing of intangible property for use in the Commonwealth will generally trigger this requirement. See [Directive 96-2](#). In such a case, the non-US corporation’s federal gross income (the amounts potentially includible in a combined report) is generally limited to income effectively connected with a trade or business in the United States plus any US Source income (and may be further limited by the application of a tax treaty). See [TIR 10-16: Non-U.S. Corporation with U.S. Income Exempt from U.S. Tax Pursuant to a Bilateral U.S. Income Tax Treaty](#).
- b) The non-US corporation’s separately determined property, payroll and sales apportionment factors average 20% or more (for this purpose, “factors” are the amount

of property, payroll or sales in the United States over the worldwide amount). In these cases, federal gross income is determined under the Code and any applicable tax treaties. Note that a foreign corporation that sources 60% of its receipts to the United States will meet this threshold. See the detailed rules pertaining to this requirement set forth at 830 CMR 63.32B.2(5)(b)2.

- c) The non-US corporation earns 20% of its gross income directly or indirectly from intangible property or service related activities (including lending) the costs of which generally are deductible by other members of the group for US income tax purposes, either currently or over a period of time. In this scenario, only the federal gross income that the corporation receives from such intangible property or services and the factors related to that income are includible in the combined group's tax computation. Further, under [830 CMR 63B.2\(5\)\(b\)3](#), the income of the foreign corporation that is included in the combined group's computation is reduced by expenses reasonably related and not disproportionate to the included income (but not below zero). Note: Income not included because it is not federal gross income still remains subject to the add-back provisions of M.G.L. c. 63 sections 31I through 31K. See the detailed rules pertaining to this requirement set forth at 830 CMR 63.32B.2(5)(b)3.

Note: The "water's edge" provisions of 830 CMR 63.32B.2(5)(b) also apply for purposes of determining inclusion of corporations within a Massachusetts affiliated group using only the common ownership standard. The unitary business standard is not applicable because that standard is not required by virtue of making the affiliated group election. Therefore, a corporation which is commonly owned but whose business activities are not unitary would nevertheless include its income, deductions and factors in the combined group computations due to its affiliated group election.

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### **Affiliated Group Election (830 CMR 63.32B.2(10))**

A taxpayer can make an election to report the income of the Massachusetts affiliated group in lieu of having to make a determination of which corporations are members of the unitary business for purposes of participating in the filing of the combined report ("Massachusetts affiliated group" as defined in [830 CMR 63.32B.2\(2\)](#)). This "affiliated group election" is essentially a variation of a federal consolidated return group. See [830 CMR 63.32B.2\(10\)](#). An affiliated group election is only permitted where: (i) a combined report is otherwise required, and (ii) the combined group includes at least one group of corporations that are required to file a consolidated federal tax return for the year in which such election is made (see [830 CMR 63.32B.2\(10\)\(a\)](#)).

Note: The "water's edge" provisions of [830 CMR 63.32B.2\(5\)\(b\)](#) also apply for purposes of determining inclusion of corporations within a Massachusetts affiliated group using only the common ownership standard. Thus, for example, the three water's edge inclusions referenced above would apply. However, the unitary business standard is not applicable because that

standard is not required by virtue making the affiliated group election. Therefore, a corporation which is commonly owned but whose business activities are not unitary would nevertheless include its income, deductions and factors in the combined group computations due to its affiliated group election (i.e., so long as it would be included within the state's water's edge concept).

For a more detailed discussion and description of this election see [10.10 Massachusetts Affiliated Group Election \(830 CMR 63.32B.2\(10\)\)](#) below.

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### **Worldwide Group Election (830 CMR 63.32B.2(5)(c))**

The combined reporting regulation allows for an alternative election to determine the combined group's income on a worldwide basis ("worldwide group election") to determine the apportioned share of the taxable net income or loss derived from the unitary business. Under a worldwide group election, each taxable member takes into account the income and apportionment factors of all of the members (wherever located) that are includible in the combined group as determined applying the unitary business principle. See [830 CMR 63.32B.2\(5\)\(a\)](#).

A worldwide group election requires that the taxpayer ignore the restriction that the group include only corporations organized in the United States. However, the greater than 50% common ownership and unitary business requirements under the default "water's edge" rules still apply. See [830 CMR 63.32B.2\(5\)\(c\)](#). Under a worldwide group election, non-US corporations determine their income, deductions and apportionment factors on a worldwide basis (i.e., their gross income is *not* limited to federal gross income which, for a foreign corporation, includes only U.S. source income).

For a more detailed discussion and description of worldwide group election see [10.5 Water's Edge or Worldwide Parameters of Combined Report](#) below.

### **Combined Group Elections – Binding Effect and Duration**

Once an affiliated group election or a worldwide group election is made it is irrevocable and binding for the current tax year and for the next nine (9) taxable years, but it may be renewed for another ten (10) taxable years. A renewal must be made on an original timely filed return by the principal reporting corporation of the combined group (or as otherwise required by the Commissioner) and will be effective for the first taxable year after completion of the ten taxable years when the prior election was in place (thus a renewal may occur on or before the final year of the election). An affiliated group election or a worldwide group election will terminate if not renewed and, if no other election is made, the status of the combined group will revert to the default "water's edge" rules. However, a new election may be made for any ten-year period thereafter, provided another group election has not been made. There are special provisions which address these situations. See Combined Group Elections – Special Provisions (Change in Reporting Method) below.

### **Combined Group Election – Effect of Merger or Acquisition**

Another example of the binding effect of a valid combined group election may be seen in the context of a merger or acquisition where a combined group with a binding election merges or acquires another combined group. In such cases, the previously-made combined group election

(whether worldwide or affiliated) does not terminate. Rather, the merged or acquired combined group becomes subject to the acquiring or merging group's previously-made combined group election.

This result is in no way affected by a change in or replacement of the principal reporting corporation of the resulting group (from that of the merging or acquiring group to that of merged or acquired combined group). Under Massachusetts law, a principal reporting corporation merely serves as agent of the members of a combined group with respect to receipt of certain legal notices and taking of certain specific actions. Its selection or designation as such does not represent or confer any legal status greater than that mentioned above.

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## **Combined Group Elections – Special Provisions**

### **Change in Reporting Method**

In some instances a change in reporting method occurs, for example, where a water's edge or worldwide reporting method is used to account for the combined group members' income and apportionment data in the immediately preceding tax year and a different reporting method is used for the current tax year. Once an auditor has discovered this and has verified that the change in reporting method is valid, any required adjustments to income and apportionment data of the group members must be verified. These adjustments are needed to, among other things, prevent income and apportionment data from being omitted, duplicated or otherwise distorted by virtue of the taxpayer's change in reporting method. 830 CMR 63.32B.2(5)(c)(4). Auditors encountering this situation must ensure that any required adjustments have been made to account for the change in combined election status pursuant to the combined reporting regulation.

### **Interaction between Combined Group Elections**

A taxpayer cannot make both a worldwide election and an affiliated group election in the same taxable year. 830 CMR 63.32B.2(5)(c)(5). Recall that, once made, both of these combined reporting elections are binding and irrevocable for 10 taxable years (i.e., the taxable year the election is made and the following nine (9) taxable years thereafter).

### **Election as Consent to Provide Documents or Other Information**

The making of a worldwide or an affiliated group election constitutes the taxpayer's consent to provide documents or other information in an acceptable language and form as reasonably required by the Commissioner. These provisions allow auditors to request additional documents or information when necessary to properly verify the validity of the taxpayer's combined group election and its tax consequences. The following examples demonstrate when an auditor might require additional documents or information when auditing a combined group that has made a worldwide or affiliated group election:

Worldwide Election - an auditor might need additional documents or might need information provided in a foreign language to be translated into English in order to verify, among other things, the appropriate members of the combined group, that the requirements of the worldwide election have been met and that the tax computation and tax reporting arising from such election are correct. [830 CMR 63.32B.2\(5\)\(c\)](#).

Affiliated Group Election - an auditor might need additional documents or other information for purposes of verifying, among other things, the appropriate members of the group, that the affiliated group election requirements have been met, that tax computations and reporting are correct, and for determining the revenue implications of the affiliated group election. 830 CMR 63.32B.2(10)(i).

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#### **10.2.4 Taxable and Non-Taxable Combined Group Members**

After determining which entities are subject to combination under [section 32B](#) and assessing what group elections, if any, are in effect, the auditor must evaluate the status of each entity as either a taxable or non-taxable member of the combined group before verifying combined group taxable net income. Whether a member of the combined group is taxable or non-taxable will affect the calculation of the combined group's taxable income and the determination of each taxable member's apportioned share of such income.

##### **Taxable Member**

Whether a member is a taxable member is determined by evaluating the Massachusetts corporate nexus rules. A "taxable member" is defined in the combined reporting statute as a member taxable under M.G.L. c. 63, sections 2, 2B, 32S, 39 or 52A. See [M.G.L. c. 63, § 32B\(d\)\(1\)](#). This would include an entity with MA nexus but not subject to tax on its income under PL 86-272.

Where a taxable member of the group is subject to tax on its net income in Massachusetts, it uses its own property, payroll and/or sales in Massachusetts as the numerator of its apportionment factor, and the combined group's property, payroll and/or sales everywhere as the denominator of its apportionment factor to determine its apportioned share of the combined group's taxable income as derived from the unitary business. [830 CMR 63.32B.2\(2\)](#). A taxable member's apportioned share of the combined group's taxable income as derived from the unitary business is the product of:

the unitary business income of the combined group

(i.e., the sum of the individual net unitary business income of all members of the combined group)

multiplied by

the taxable member's respective apportionment percentage

(where the numerator of each factor is the taxable member's in-state (MA) factor and the denominator of each factor is the sum of all group members' factors everywhere\*)

\* For purposes of the calculation, transactions between members of the combined group with respect to the unitary business are generally disregarded in calculating a taxable member's

apportioned share of that income. See [830 CMR 63.32B.2\(7\)\(g\)](#). There may also be a so-called “Finnigan” adjustment required that will mean that the taxable member’s numerator may be modified to include Massachusetts sales made by other non-taxable members. See also [830 CMR 63.32B.2\(7\)\(b\)](#).

**Note:** [M.G.L. c. 63 § 32B](#) applies to the income measure of excise. A corporation subject to combined reporting and taxable under [M.G.L. c. 63, § 39](#) separately calculates its non-income measure of excise. If it is taxable in another state, it will determine its apportionment percentage based on its own separate business activities (without regard for the activities of any other businesses) in order to calculate its non-income measure of excise. See [10.6.11 Combined Group Taxable Income - Relation to Non-Income Measure](#).

### **Non-Taxable Member**

Conversely, a “non-taxable member” is any member of the combined group that is not subject to tax on its net income in Massachusetts under section 2, 2B, 32D, 39 or 52A. [830 CMR 63.32B.2\(2\)](#). Because it is not subject to tax on its net income in Massachusetts, a non-taxable member merely contributes its income and factor attributes to the calculation of tax imposed upon taxable group members. A non-taxable member does not itself calculate a net income tax. **Note:** In general, when a corporation is a non-taxable member it will not owe an income or non-income measure of excise. However, a member that is not taxable on its net income by claiming the protections under [Public Law 86-272](#) (15 U.S.C. § 381 *et seq.*) may still be taxable under M.G.L. c. 63, § 39 and therefore subject to the non-income measure or payment of the minimum excise amount.

### **Taxable Member - Continued General Application of M.G.L. c. 63**

Auditors must remember that even though a corporation included as a taxable member in a combined group takes an apportioned share of the combined group’s taxable income instead of the income and deductions it may have realized separately, it still generally retains its separate identity under [M.G.L. chapter 63](#). Therefore, each member of the combined group is responsible for tax based on its taxable income or loss, whether apportioned and/or allocated to Massachusetts, which includes each member’s apportioned share of unitary business income of the combined group, any other types of taxable income of such member and such member’s separately calculated non-income measure.

### **Examples Where Taxable Member Retains its Separate Identity**

The following are examples of situations where a taxable member retains its separate identity despite being responsible for tax on its apportioned share of the combined group’s taxable income:

- ✓ Each taxable member uses the apportionment formula that applies specifically to the type of entity it is and/or the business activities it conducts but on a group basis. So, for example, a manufacturing corporation that is required to use a single sales factor apportionment formula uses that formula to determine its apportioned share from of the combined group’s taxable income, although other members of the same group may use a

different apportionment formula. Also, except as otherwise required by a “Finnigan” sales factor adjustment, the numerator of the taxable member’s property, payroll or sales factors will be that member’s in-state property, payroll or sales.

- ✓ If a taxable member has taxable net income from a source other than the unitary business (i.e., non-unitary business income), that non-unitary business income is added to its apportioned share of the combined group’s income before the income measure of excise is determined. Such non-unitary business income may include apportionable income that derives from a business other than the combined group’s unitary business or allocable income.
- ✓ Each taxable member of the group determines its own tax based upon its own respective tax rate (i.e., a corporation taxable under [M.G.L. c. 63, § 39](#) may be taxed at 8% while a financial institution in the same combined group may be taxed at 9%).
- ✓ Although combined reporting allows for some sharing of losses and credits between taxable members, such losses and credits are the tax attributes of the corporation that actually generated them. As such, the losses and credits are only eligible for carry forward to future years by such corporation. Similarly, when a corporation possessing such a carry forward loss or credit leaves the combined group (or is dissolved or merged out of existence) it takes the losses or credits with it.
- ✓ Further, if a combined group member is subject to the non-income measure, it must separately calculate its non-income measure and apportionment factors on a single-entity basis, even in circumstances in which such member is not subject to tax on its income either through the combined report or otherwise. [830 CMR 63.32B.2\(1\)\(c\)\(3.\)](#).

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## 10.3 The Corporate Combined Reporting Audit Process

This section covers the procedural steps to be followed by the auditor in order to complete the audit of a corporate combined report. For further details and information regarding the corporate excise audit process generally auditors should refer to section [9.2 Corporate or Financial Institution Excise Audit – Overview of the Audit](#). Some of the topics and discussion there are duplicated here by necessity to reinforce the similarity of the process.

### 10.3.1 Generation, Assignment and Determination of Audit Leads

Supervisors are primarily responsible for generating and assigning audit leads to auditors who are required to evaluate those leads to determine whether a combined reporting audit case should be opened. Audit leads are often generated through the DOR tax processing software system based on a variety of audit selection criteria. Audit leads assigned by supervisors to

auditors should receive a thorough but efficient pre-audit evaluation of audit-worthiness and the potential scope of audit review.

### **Working Audit Leads**

Auditors are primarily responsible for working their assigned audit leads. Auditors must be efficient in processing their assigned audit leads because the number of leads generated by the DOR tax processing system greatly exceeds the number of audit cases ultimately assigned. Thorough but timely turnaround is expected. Auditors must work assigned leads and submit a pre-audit analysis to their supervisor during the lead evaluation process.

Assigned leads should be constantly moving in and out of the auditor's work inventory. For example, if it is relatively clear that an assigned lead is not worth auditing, then the auditor should quickly document the lead determination and forward it to his or her supervisor for review and closure if the supervisor is in agreement with such determination. As the auditor processes assigned leads the supervisor will keep new leads coming into the auditor's work inventory.

### **Working Audit Leads-Checklist**

The auditor should refer to the following checklist when working an assigned lead, keeping in mind that leads are potential (not actual) audit cases and as such need to be reviewed and evaluated accordingly:

- ✓ Be efficient in processing assigned leads - speed of resolution requires a 30-day lead determination timeframe. Auditors should not hold onto assigned leads in perpetuity. The auditor should inform his or her supervisor if he or she is unable to meet the 30-day determination timeframe
- ✓ Perform a thorough but abbreviated pre-audit research and evaluation - a lead, like an audit, can continuously unfold and progress and represents a cumulative review process
- ✓ Work with your supervisor during lead evaluation – the auditor should discuss with his or her supervisor:
  - ⇒ lead review sources and other potential avenues
  - ⇒ lead review scope – where to look and where not to look to make the determination
  - ⇒ overall review results and how the results support the proposed lead determination
- ✓ Support lead determination – the auditor must attach supporting documentation to the assigned lead which helps substantiate the proposed lead determination. In addition, the auditor should add lead notes to further support the lead determination. These sources will contribute to the lead determination write-up

- ✓ Draft lead determination write-up – the auditor must discuss the information reviewed (i.e., sources and nature of data) and explain how the reviewed information supports the proposed lead determination to audit or not to audit the taxpayer
- ✓ Attach Determination Write-up to Lead Task and submit to Supervisor – the auditor must attach the lead determination write-up and submit it to his or her supervisor with a proposed lead determination request
- ✓ Meet with Supervisor to Discuss and Finalize Lead Determination

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### **Audit Lead Determination**

After initial vetting of the audit lead is completed by the auditor and the proposed lead determination is submitted to the supervisor, the audit lead process culminates in collaborative assessment and determination by the auditor and the supervisor who assigned the audit lead. If an assigned audit lead is determined to be audit-worthy, the audit supervisor will convert the audit lead and assign it as an actual audit case for processing, and will designate the scope of audit case review. Audit leads that are determined to be not audit-worthy will be closed out by the supervisor and the auditor will perform no further work on the lead. In this regard, there are generally three (3) options for a supervisor making an audit lead determination:

1. Full-blown Field Audit Case-Supervisor assigns the lead to the auditor as a full-blown field audit case (i.e., the auditor will travel to the taxpayer's place of operations to perform a comprehensive review of the combined report including the address of multiple issues discovered in pre-audit and any other issues which may arise during the audit review);
2. Single Issue or Limited Scope Audit Case-Supervisor assigns the lead to the auditor as a single issue or limited scope audit case (i.e., there are 1 or 2 issues to be reviewed that do not warrant a full-blown field audit case);
3. Not Audit-worthy-Supervisor closes the lead as not audit-worthy and it is not assigned to the auditor (no further audit work is performed and no case is assigned). The supervisor will document the determination (including the reason for the non-selection which is important for use in creating future audit leads) and close the lead without further activity

Note: The importance of quickly closing leads which are not audit-worthy should not be overlooked by the auditor, as these generally represent the greatest number of audit lead determinations. Auditors should review as many assigned leads as possible, regardless of the ultimate lead determination, to maximize overall audit assessment potential by reaching the greatest number of taxpayer returns. In so doing, auditors

may discover important audit issues by reviewing a greater number of leads, thereby resulting in greater assessment potential.

### **Single-Issue or "Limited Scope" Audits**

If a lead is converted and assigned by the supervisor as an actual audit case, the auditor will generally process the case as a full-blown field audit. However, on occasion the lead may be processed instead as a desk audit.

From time to time, supervisors will assign leads as single-issue or "limited scope" audits so that auditors may review one or two primary issues or aspects of a taxpayer's return (e.g., the applicability of a specific credit or compliance with a specific provision of the law). Some single issue or limited scope audits may not entail a field work component or may be limited to performing an opening and exit conference. In such cases, the limited nature of the examination and its actual scope must be disclosed to the taxpayer at the outset of the audit and also noted in the audit case log and addressed by the auditor in the audit report. If any other issues are encountered during this limited review, the auditor should briefly assess the newly-discovered issues and, if noteworthy, immediately inform the supervisor or manager at that time to discuss and address the same. This is needed so that a decision can be made whether to further expand the scope of the audit to address such issues or to simply maintain the initial limited audit scope. When and if it is decided to expand the audit scope, the taxpayer should be informed regarding what additional issue(s) and related information requests will be involved. Auditors should consider discussing the need for a waiver with the supervisor, if it is anticipated that additional time will be necessary to address the additional issue(s) which have expanded the scope of audit review.

### **Notation of Lead Assignment- Checklist**

Once a lead has been converted to an audit case by the supervisor, the auditor assigned to the case should enter a notation on the DOR tax processing software system indicating that an audit case for this taxpayer has been assigned from an audit lead generated by a supervisor. The system notation should include among other things:

- ✓ the supervisor who assigned the lead as an audit case
- ✓ whether the audit case is a full-blown field audit, single issue or limited scope audit (if single issue or limited scope indicate if field or desk review will be performed and a brief scope of review summary)
- ✓ a brief description of the primary audit issue(s) involved and related potential audit assessment value

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### **10.3.2 The Corporate Combined Reporting Audit Plan**

Once the supervisor converts the lead and assigns it as an audit case, the auditor will work with the supervisor to complete an audit plan and process the audit review in accordance with the audit plan.

An audit plan is a tool used by the auditor to manage the audit. It identifies the issues to be addressed and the steps the auditor intends to take to address them. It is constructed at the beginning of the audit and should take into account (1) the risk that a particular issue or item to be investigated has resulted in a substantial understatement of tax and (2) the amount of audit resources expected to be expended in verifying such issue or item. For additional audit plan case evaluation information see the detailed discussion of [Corporate Audit Risk Analysis](#) in Chapter 9. An audit plan is a living plan of action. The auditor is expected to modify the audit plan as new information becomes available, adding or eliminating tasks based on the likely value of completing them after discussing and evaluating any plan modifications with the supervisor. The auditor should be prepared to review the audit plan with the supervisor or with the taxpayer upon request at any time during the course of the audit case.

### **Corporate Combined Reporting Audit Plan Development - Checklist**

The auditor must recognize the legal and procedural impact of corporate combined reporting upon the audit review as this will guide the creation and implementation of the audit plan. Proper application of the combined reporting rules and requirements directly affects other issues, so it should be the primary consideration when the auditor is developing the combined reporting audit plan.

The auditor must analyze and evaluate taxpayer records and other information (some of which was already available and reviewed by the auditor for the pre-audit review of the assigned audit lead) in order to develop a formal plan for the assigned audit. The following information should be reviewed for this purpose to the extent it is available:

General Taxpayer Information. The auditor should review the taxpayer's company website about its overall business, products, history, offices and customers. In most instances the taxpayer's Annual Report will be available for review from the taxpayer's website. Other reliable sources may be reviewed for additional information, including SEC filings such as 10-K reports and other filings and information relating to major corporate transactions (e.g., corporate reorganizations, refinancings and restructurings, mergers and acquisitions and off-shore expatriations or repatriations)

Form 355U and Computational Schedules - this is a primary source of issues to be addressed in the audit. The standard corporate combined reporting audit work papers package automatically checks many calculations that occur within the combined report (i.e., does line 1 minus line 2 actually equal line 3). While those discrepancies should already be resolved, verification of amounts entered into rather than calculated within the combined report is the auditor's responsibility.

The auditor should review Form 355U (and any related amended returns) and the computational schedules as reported to evaluate and assess, among other things, combined taxable net income calculations, combined income apportionment, tax credits and Net Operating Loss (NOLs) generated, used, shared and/or carried over. Year-to-year comparison of the information in consecutive returns may be helpful in order to look for year-to-year changes in, among other things, overall combined group composition, status

of combined group elections, combined taxable net income and apportionment percentages and generation, use, sharing and carryover of credits and NOLs. Highlighting this review process are, among others, the following schedules:

Schedule U-M: Each corporation the taxpayer included in the combined report is represented in the income calculations by a Schedule U-M which identifies the member and shows its separate income and deductions. While no similar schedule is part of the return for apportionment purposes, the taxpayer should have work papers listing the contributions of members to the apportionment denominators.

Form 355U:

Group Election Options: The taxpayer's combined group election (if any) is shown on page 1 of Form 355U (item 2 for years 2010 and thereafter). What election, if any, the taxpayer made in filing the return matters in determining who is required to be included in the group and therefore whether or not a member can be excluded from the group

Note: Auditors should typically compare the income and the apportionment factors of a member and may question members with factors that appear large or small in relation to their income and expense items. Factor contributions by member are usually not available until after the audit is opened but estimates for sales may be made from the income statement information on schedule U-M.

Prior audit reports, logs, and work papers for the taxpayer (including any decisions from the Office of Appeals on the prior audit cycle). Issues resulting in changes from prior cycles should be checked to see that the taxpayer has made the appropriate adjustments on later returns. Carry forwards reflected in the final audit work papers should be checked against figures the taxpayer is using on returns for the current periods and adjusted accordingly

DOR Audits of Other Tax Types. If the taxpayer has not recently been audited for corporate excise tax, but has been audited for other tax types (e.g., Sales & Use Tax), that audit report and log should be reviewed for information on, among other things, the taxpayer's operations and any claimed qualification (e.g., as a Manufacturing or Research and Development corporation).

Federal Change filings for the years to be audited or other recent years should be reviewed. These reports may show changes that directly affect the tax attributes on current year returns, or they may show areas where the taxpayer was incorrectly calculating US taxable income or credits in prior years that require examination in the current audit cycle. Note: The auditor must confirm the date of the last federal tax audit identified in previous research (an ongoing or recent federal audit may significantly affect what will be reviewed)

Any recent corporate excise tax abatement filings. Changes to any tax attributes carried forward into the audit period should be matched against the figures used on the returns and adjusted accordingly

SEC Filings. Form 10-K (if the taxpayer is required to file one) should be reviewed, and the financial statements reported therein should be compared to information on the federal tax return to identify any issues on the financial statements that should have been reflected on the tax filings.

DOR Filings. DOR system records should be reviewed to verify that the taxpayer has filed all required returns up to the present. This review is not limited to corporate excise tax filings. For example, if the taxpayer has failed to file withholding or sales tax returns then the auditor should address this issue during the audit

After reviewing all of this information, the auditor will meet with their supervisor to discuss the overall scope of the audit, first in terms of items in the tax return to be addressed and then the records to be reviewed and the projected time allotted to review those records. It is not expected that auditors will give all aspects of the return equal attention. On the contrary, auditors are expected to manage and allocate more of their time to significant issues which may render meaningful audit adjustments and, in some cases, to relent on other issues where the return on work expenditure is inefficient and will not result in relatively meaningful audit results. Issues must be weighed in accordance with the value of potential audit adjustments which are at stake.

After the auditor and supervisor have agreed on the scope of the audit, the auditor will prepare an initial audit plan and initial information document requests (IDRs). Additional IDRs will be prepared as necessary to address specific issues within the agreed scope of the audit. A number of standard IDR forms have been developed by Audit which should be utilized as models when addressing certain common issues that are within the scope of the audit. Preparation of these IDRs must be documented as part of the audit case log.

If the auditor discovers or determines that the work remaining to complete the audit is likely to require significantly more time than originally planned, the auditor must immediately discuss the circumstances with their supervisor and determine how to proceed accordingly. Auditors must periodically communicate audit case progress with their supervisor. When novel or complex issues arise which were not anticipated in the audit plan the auditor may need to reach out for further guidance and advice after initial review and research of such issues. In some cases, as the auditor begins to carry out the audit as planned, additional research and subsequent discussion with the supervisor determines that an audit is not warranted (e.g., after additional research and initial IDR responses are reviewed the auditor and supervisor agree that the issue triggering a limited scope audit has not developed as anticipated). In those cases the supervisor may suspend the audit plan, inform the taxpayer and close the case prior to the audit plan conclusion. Auditors should not hesitate to work with their supervisor to suspend and close cases when the goal(s) underlying the audit plan are no

longer achievable. In such situations, this is the most efficient and professional manner in which the auditor can process the case.

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### **10.3.3 The Corporate Combined Reporting Audit - Issue Checklist**

The audit of a combined report raises numerous questions for the auditor to consider. It is the auditor's duty to identify potential audit issues, evaluate audit assessment potential and prioritize accordingly. Auditors should always consider the potential of an issue when determining time allocation and directing efforts toward completing an assigned audit case. The following presents an inclusive checklist of corporate combined reporting audit issues. Auditors are not expected to thoroughly work through each and every issue. Instead, all issues must be considered, evaluated and prioritized by the auditor, in discussion and collaboration with his or her supervisor, on a case by case basis. If the auditor determines that an issue warrants review and prioritizes it accordingly, it should be made a part of the audit plan.

A combined reporting corporate excise audit plan will generally address one or more of the following issues depending upon the scope of the audit review and the facts and circumstances of the specific audit case:

- ✓ Verification of whether the taxpayer meets the threshold requirements for filing a combined report (or whether a corporate excise return for a stand-alone corporation should have been filed): a corporation with nexus in Massachusetts engaged in a unitary business with one or more other includible corporations related by common ownership thereby triggering the combined reporting requirement-see [10.2.2 Combination under M.G.L. c. 63 Section 32B](#)
- ✓ Verification of the chosen combined group election, if any (i.e., worldwide or affiliated group election), including whether the election is valid and in force by tracing the history of the election, the effect of the election on the group composition, and the tax consequences arising from the election-see [10.2.3 Corporate Combined Reporting - Group Election Options](#)
- ✓ Verification of which corporations should be included in or excluded from the combined group-this includes a consideration as to whether the corporation is an includible corporation and the application of the tests for unity (including the common ownership standard and the unitary business presumptions and inferences) -see [10.4 Corporations Included in or Excluded from the Combined Group](#). Note that where the combined group has made an affiliated group election, there is no unity test but the common ownership standard remains relevant.

- ✓ Verification of which corporations should be classified and treated as either taxable or non-taxable combined group members-see [10.2.4 Taxable and Non-Taxable Combined Group Members](#)
- ✓ Verification of whether (1) combined group members that the taxpayer reports as non-taxable are in fact non-taxable and (2) whether there are corporations in an affiliated group that were previously non-filers or non-taxable members that should have been filers or taxable members.
- ✓ Verification that (1) where there is an included REIT in the combined group that the REIT's income is being subject to a single level of taxation, and (2) to the extent an intercompany dividend is made by a REIT, and the dividend is eliminated in the computation of the combined group's taxable income, the REIT must also reduce its dividends paid deduction by the same amount as the dividend elimination amount. See [DD 10-5: Further Guidance Regarding the Application of the Combined Reporting Regulation, 830 CMR 63.32B.2](#)
- ✓ Verification of the combined group's taxable net income calculation including what income and deductions should be included, what eliminations or deferrals or Massachusetts adjustments apply, treatment of non-unitary business income and any other special rules or provisions-see [10.6 Corporate Combined Reporting - Group Taxable Income](#)
- ✓ Verification that the combined group's income apportionment percentage was properly calculated, including each combined group member's income apportionment percentage, what apportionment factor eliminations or adjustments should be made, what apportionment formula should apply for each taxable member of the combined group, and any other special apportionment rules or provisions that may apply-see [10.7 Corporate Combined Reporting Group Income Apportionment](#)
- ✓ Verification of the net operating loss (NOL) carry forwards of each of the combined group's taxable members, including the computation of the loss, deduction and sharing of such losses, amounts to be carry forward, and any limitations or offsets-see [10.8 Corporate Combined Reporting Group - Net Operating Losses](#)
- ✓ Verification of the generation, sharing and application of credits by members of the combined group and whether any recapture provisions, if relevant, have been applied – this may be limited to a review of the appropriate schedules for obvious errors or may involve detailed examination of one or more of the activities that allowed the taxpayer to claim the credit-see [10.9 Corporate Combined Reporting Group - Credits](#)
- ✓ Verification of non-income measure calculations for each member of the combined group (taxable and/or non-taxable as applicable)-including whether non-taxable members asserting the protections of P.L. 86-272 have paid the greater of the

minimum excise or their separately calculated non-income measure-see [10.11 Relation of Non-Income Measure to the Combined Report](#)

- ✓ Recalculation of the excise and the limitations on the use of any credits and the final corporate excise tax calculation for each member including any recapture, other taxes and credits which may apply-see [10.12.1 Recalculation, Recapture, Other Taxes and Credits](#)
- ✓ Confirmation of whether there are any special circumstances or situations requiring adjustments or application of combined reporting rules or other legal authority outside of the combined reporting regulation-see [10.12 Other Combined Reporting Provisions; 10.1.3 Effect of Combined Reporting on Other Legal Authority](#)

Note: These procedures address issues from the standpoint of an audit of a previously filed combined report. Auditors should adapt them as necessary if they determine, during the course of an audit where the taxpayer filed a separate stand-alone return, that the taxpayer should have filed a combined report with one or more other businesses but did not do so.

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#### **10.3.4 The Corporate Combined Reporting Audit – Initial Contact with Taxpayer**

Once the auditor and supervisor have discussed and determined the audit plan, the auditor will contact the taxpayer and schedule the initial field audit conference appointment. A discussion of the initial information document requests (“IDRs”) to be issued may assist in the audit scheduling process, and minor changes to the IDRs can be made if and when appropriate. If the taxpayer wishes to delay or defer the initial audit conference, the auditor should request and secure an executed [Form A-37](#) (waiver) from the taxpayer to ensure that there is adequate time for the audit review process due to any proposed delays to the audit start date at the behest of the taxpayer.

After establishing an audit start date, the auditor will generate and send out an Audit Notification Letter and an initial set of Mandatory IDRs using the DOR tax processing software system. In the Audit Notification Letter the auditor should direct the taxpayer to the DOR’s online Guide to the Department of Revenue including the "[Taxpayer's Bill of Rights](#)" and "[DOR audit process](#)" along with any other required online references or notices (which may vary from time to time).

#### **10.3.5 Opening Conference – Corporate Combined Reporting Audit**

A corporate excise tax field audit typically begins with an opening conference at the taxpayer’s business location, or in some instances at the office of the taxpayer’s legal representative (e.g., CPA or Accounting Firm). At this initial meeting, the auditor is required to go over the purpose and initial scope of the audit and the audit process, and to outline the post-audit and appeal process including appeal alternatives. The auditor should inform the audit supervisor in advance of the opening conference date so that the supervisor may attend if scheduling allows.

In such situations the audit supervisor will explain the post-audit and appeal process and alternatives with the taxpayer.

The auditor is expected to secure additional details about the taxpayer and its business operations so that the audit may be conducted more efficiently and any additional audit issues may be identified for review. Some of these issues are specific to Corporate Tax audits and others, more generally applicable across tax types, are discussed in **Chapter 4** of the **Field Audit Procedures Manual** - [Opening Conference](#).

Prior to the opening conference, the auditor should prepare a list of questions or topics to be addressed (other additional questions should also be raised when appropriate during the interview). Typically in the opening conference for a corporate case the auditor should address the following tax type specific issues:

- ✓ Determine if there have been any substantial changes in the taxpayer's business or organization either in the recent past or after the periods under audit, such as a change in control, purchase or sale of a division, entry into a new market or a restructuring or reorganization of existing operations.
- ✓ Determine where the taxpayer has facilities and what activities are performed at each location (this is especially important in many cases to determine the location of manufacturing or R&D activities and the location and nature of any sales offices).
- ✓ Determine if the taxpayer has any agreements with Massachusetts municipalities for full or partial exemption from local property taxes.
- ✓ Determine if the taxpayer has any employees based in their homes or at any location other than an office of the taxpayer (including offices belonging to customers or taxpayer affiliates). If so, find out where these other locations are, what these employees do and for whom they work.
- ✓ Determine who and where the taxpayer's customers are and what services it provides to those customers (even if its primary business is selling tangible property).
- ✓ Identify the taxpayer's revenue streams and note any differences between revenue that is recognized for book purposes and income stated on the tax return.
- ✓ Determine how revenue streams are segregated and how each is treated for allocation and apportionment purposes. For sales treated as receipts from the sale of tangible personal property for apportionment purposes, how does the taxpayer determine the destination state? For sales of services (i.e., sales of "other than tangible personal property"), how does the taxpayer identify separate items of income and how do they identify the location of sales of services when allocating those separate income items.

- ✓ If the taxpayer receives royalties, determine what property is being licensed, how the amount due is calculated and how the royalties are assigned for purposes of apportionment.
- ✓ Review the role of each corporation in the combined filing and the location of its business activities. Determine how the taxpayer identifies and eliminates intercompany transactions in the federal consolidated income tax return.
- ✓ Ask about the existence of any related parties that are not included in the combined group and determine the nature and purpose of any transactions between the taxpayer and those related parties.
- ✓ Determine how prices and other terms are established for transactions between related parties when one of those related parties is not included in the combined group (including transactions between members of a federal consolidated group and transactions between the taxpayer and other related parties). Ask the taxpayer if they have agreed to any pricing agreements with the IRS for transactions involving members of the federal consolidated group and foreign affiliates.
- ✓ Identify and evaluate taxpayer's internal controls, especially as they relate to proper allocation of income and expenses and management of fixed assets between related parties that are not included in the combined group.
- ✓ What are operational managers responsible for and what transactions affect the tax return but are outside of the scope of responsibility of such managers? Is there a separate manager with P&L responsibility for each legal entity?
- ✓ Confirm any other information the auditor may have acquired from the pre-audit review on which the auditor expects to rely in completing the audit.

In preparing this list of issues to address in the opening conference (and throughout the audit), the auditor should bear in mind the degree of audit risk associated with each possible issue. Auditors should probe to understand the controls the taxpayer may have in place – what is already being done to ensure that the figures being reported are accurate. The auditor may sometimes choose to initially rely on a taxpayer's internal controls until evidence surfaces that they are not effective. To the extent a third party may have reviewed all or part of a taxpayer's return the auditor may choose to consider that person's work in planning his/her own review; this may involve an IDR for workpapers or correspondence between the taxpayer and that third party so that the auditor can verify the scope of that prior review. As always, areas that will have little or no impact on tax liability for this particular taxpayer should not be a primary focus of the audit.

As soon as practicable after completion of the opening conference, the auditor should schedule a tour of the taxpayer's facility. If the auditor has determined in advance that a facility tour is warranted (e.g., the taxpayer is a manufacturer or is claiming the research credit), the tour can be scheduled on the date of the opening conference if the taxpayer contact is available to provide one. The facility tour can frequently identify other issues to be addressed during the audit and helps the auditor get a better understanding of the taxpayer's business operations. The auditor may dispense with the tour if it is not expected to be of value. If, as the audit progresses, the auditor later determines that a tour would be relevant it should be requested in writing. Both the opening conference and the tour (or the decision to forego the tour) must be documented.

#### Statutory Interest Rate Reduction (M.G.L. c. 62C § 32(f))

The Department of Revenue is obligated to complete audits in a timely manner. Under M.G.L. c. 62C § 32(f) the rate of interest on a deficiency assessment is reduced if the NIA is not issued within 18 months after the date of the opening conference. The interest rate reduction (and a further reduction after 36 months) applies unless the taxpayer is responsible for the extended duration of the audit.

The determination of whether the delay in completing the audit was for a reason that would not result in an interest rate reduction (and the extent to which it should be attributed to such reasons) is a question of fact. If the auditor at any time believes this time limit will be exceeded and that the responsibility for some or all of the delay rests with the taxpayer, the auditor may (after discussing the issue with the supervisor/manager who must agree that the delay is attributable to the taxpayer) suggest the taxpayer sign Form A-32 to remove the issue of the interest rate reduction from the audit. Examples of when this might be appropriate would include a suspension of an audit already in progress at the request of the taxpayer or a request by the taxpayer to go to mediation.

See [FAPM Chapter 4](#) for further details regarding Form A-32.

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### **10.3.6 Detailed Review of Case Plan Issues – Corporate Combined Reporting Audit**

After the opening conference the auditor is expected to complete the case using the audit plan created for that specific audit as a tool. Specific Information should be requested and reviewed to address issues identified in the plan. As the case develops the auditor may need to follow-up with more detailed requests on some issues. Other issues may be resolved, either with proposed changes or with acceptance of the taxpayer's return position.

The auditor gathers the factual information needed to address audit issues in a timely and efficient manner by issuing detailed Information Document Requests (IDRs). IDRs, representing formal written requests for the taxpayer to produce specific documents or other (specific) evidence or information to verify the tax treatment of any item on the return, establish a record of correspondence and communication between auditor and taxpayer. An IDR must specify a response date.

In an effort to get the required information in the most efficient manner, the auditor may discuss particular issues with the taxpayer and the nature and context of a potential IDR. The knowledge of the taxpayer's contact person may assist the auditor in determining what records are most likely to provide the desired information but it is the auditor's responsibility to determine what records are needed to complete the audit. If, during such discussions, the auditor makes a verbal request for information, a follow-up request should be made in writing to document the specific items to be produced. This written follow-up should be made as soon as possible to minimize the possibility of the taxpayer expending resources in producing the wrong records.

Auditors are expected to review IDR responses as soon as possible after they are received. Auditors may wish to discuss the response with the taxpayer as they are reviewing it to clarify any part of the response. To the extent the response received does not provide the required information, a written follow-up communication is required. If the information is not provided, the auditor and supervisor should discuss alternatives, including whether use of an administrative summons is necessary and, if so, what is needed to carry out the process in light of the facts and circumstances of the audit case. In many cases, a more formal escalation of the issue with the supervisor and with the taxpayer will generally result in obtaining the necessary information without the need for going through the actual process of seeking an administrative summons. See [9.2.3 Detailed Review of Case Plan Issues – Corporate or Financial Institution Audits](#).

More commonly, the auditor's review of the information provided in response to the first round of IDRs will indicate some specific additional documentation is needed. Requests for additional information should be made through additional IDRs when necessary. In addition to copies of the IDRs as actually issued, the auditor is required to maintain a log of all requests for information recording the date issued, the date the response was received and notes about the sufficiency of the response or follow-up action. A sample IDR Control Sheet can be found in the [Appendix](#) to FAPM Chapter 9.

The auditor should follow-up on "past due" IDRs on a continuing basis as part of the audit. At the conclusion of the audit, a final list of open IDR's should be provided to the taxpayer together with a final deadline so that both the taxpayer and the auditor can ensure that all issued IDRs have been addressed and the taxpayer has a final opportunity to provide whatever information it has to respond to the audit information requests.

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### **10.3.7 Presentation of Changes - Corporate Combined Reporting Audit**

The auditor's review will identify potential changes to the treatment of items on the taxpayer's return which should be organized and presented to the taxpayer as they are developed prior to the presentation of summary workpapers showing the net change to tax. Proposed changes to items in the return should be addressed to the taxpayer on an issue by issue basis with reference to the law and facts accompanied by specific IDR requests. Each transmittal should request

response(s) by a certain date, and the taxpayer should be encouraged to contact the auditor with any questions or concerns.

If there are changes made to the treatment of items on the tax return, there will be a series of corresponding mathematical calculations set forth in the workpapers which will result in a change to tax. Although standardized work papers may automatically project these changes through the entire return as they are entered, the auditor's focus (and the taxpayer's as well) should be on determining if the proposed changes to individual items should be made or if, upon review of the taxpayer's response, the proposed change should be modified or even withdrawn. Changes to multiple items will each affect the overall tax calculation, and the actual change to tax, if any, will not be known until each of the open issues are resolved and the workpapers are finalized. The proposed net change to tax should normally be presented only after the auditor has made decisions on all open issues.

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### **10.3.8 Exit Conference – Corporate Combined Reporting Audit**

An exit conference for a corporate combined reporting audit should typically be scheduled *after* the taxpayer has responded to the proposed audit changes and been provided with final workpapers reflecting the overall audit calculations. The auditor and the audit supervisor should be prepared to discuss positions taken during the audit in order to assist the taxpayer in determining whether or not there are disputed audit issue(s) for which an appeal should be filed. If there are areas of substantial disagreement and the case otherwise qualifies, Audit may propose mediation of the un-agreed upon issues. If mediation is an option, the auditor may wish to prepare pro-forma workpapers without the un-agreed upon changes to ensure there is no disagreement as to the specific amount in dispute.

Where there are agreed changes that are likely to have significant effect in subsequent tax years, and where the taxpayer has already filed returns, the auditor may discuss whether the taxpayer will file amended returns consistent with the agreed upon audit findings. If a follow-up audit is indicated, either because the taxpayer is unwilling to amend the returns or because there are significant un-agreed upon changes, the department's intentions of performing such audit should be discussed with the taxpayer at this time.

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## **10.4 Corporations Included in or Excluded from the Combined Group**

In order to verify the reported taxable income calculation of a combined group, the auditor must first verify that the correct corporations have been included in the combined group for each of the tax years under audit.

This process entails verifying member inclusion and exclusion to ensure the correct combined

group composition. This includes, among other things, verification of any combined group election (whether made on the return or omitted from the return where a valid election is still in effect from a prior year).

Example: if the taxpayer made a combined group election for the current tax year, the election is normally invalid only if it was inconsistent with an election made in a prior year or if the same election was made within three (3) years after the same election lapsed. See [10.2.3 Corporate Combined Reporting Group Election Options](#).

The following subsections provide auditor checklists and tests for evaluating combined group member inclusion and exclusion and more detailed discussion and instruction relating to combined reporting requirements, including the unitary business and common ownership standards and which corporations may be subject to combination under section 32B. It is suggested that auditors review and apply these tests, and refer to the more detailed discussion of the unitary business principle and common ownership standards as needed, in order to ensure that the proper combined group composition is verified under audit.

#### **10.4.1 Types of Corporations Subject to Combined Reporting - Checklist**

As previously summarized, combined reporting is required under section 32B whenever a corporation (1) is taxable on its net income in Massachusetts (i.e., has nexus), (2) is engaged in a unitary business with one or more other includible corporations related by common ownership and (3) is one of several types of corporations that is subject to combined reporting. 830 CMR 63.32B.2(2).

##### **Checklist – Determining Combinable Corporations**

It is probably more expedient for the auditor to first address whether a proposed combined group member is actually one of the several types of corporations that are simply not subject to combined reporting than to engage in applying the litany of tests to establish inclusion or exclusion through nexus, common ownership and/or unitary business.

The auditor should determine whether the corporation being tested is an entity of a kind that is subject to tax (or would be subject to tax if doing business in Massachusetts) under M.G.L. c. 63 §§ 2, 2B, 32D, 39 or 52A, or an entity described in M.G.L. c. 63 §§ 20 through 29E that does not qualify for treatment as a life insurance company taxable under [IRC § 816](#) or an insurance company taxable under [IRC § 831 and corporations described in M.G.L. c. 63 sections 38B \(securities corporations\) and 38Y \(entities exempt under IRC section 501\), and certain non-U.S. corporations](#). The following checklist is helpful to the auditor in evaluating and determining whether one or more entities are subject to combined reporting under section 32B:

- ✓ Corporations subject to combination under section 32B (assuming they meet the common ownership and unitary business standard) include any corporations taxable in Massachusetts under M.G.L. c. 63 sections 2 (financial institutions), 2B (financial institutions that are S corporations), 32D (S corporations), 39 (general business corporations) or 52A (pre-2014 utility corporations), and entities described in M.G.L. c.

63, §§ 20 to 29E (if they do not qualify as insurance companies under section 816 of the Code or as life insurance companies under section 831 of the Code)

- ✓ The combined reporting regulation excludes some corporations from a combined report even if they are engaged in a unitary business with a taxable member of the group. These include corporations described in M.G.L. c. 63 sections 38B (securities corporations), 38Y (entities exempt under IRC section 501), insurance companies that qualify as life insurance companies under section 816 of the Code, and insurance companies (other than life insurance) subject to tax under section 831 of the Code
- ✓ The text of M.G.L. c. 63, § 32B(c)(1) specifically includes as entities eligible for inclusion in a combined report a real estate investment trust (REIT) (under Code §§ 856 through 859) and a regulated investment company (RIC) as referenced under Code §§ 851 through 855 (note that although a RIC itself is exempt from the c 63, § 39 excise under § 68C, its income and deductions are included in calculation of the combined group's income if the common control and unitary business requirements are met). In many cases, however, a public REIT or RIC may not be eligible for inclusion because it does not meet the common ownership standard (i.e., a corporation is only required to be included in a combined group with one or more other corporations if, among other things, it is related with such corporations by common ownership).
- ✓ A US Corporation that is not itself taxable in Massachusetts is still subject to combination if it is an entity of a kind that would meet the above standards if it was doing business in this state (see c. 63 § 32B (c)(1)). This also applies to non-US corporations that are within the MA water's edge. Such corporations contribute income, deductions and factors to the formula used by the taxable member to determine its Massachusetts apportioned share of its income from the unitary business
- ✓ Non-US Corporations that have nexus to MA would also be included if they are engaged in the unitary business or are under common ownership (note that when there is an affiliated group election only common ownership is required)
- ✓ Captive Insurance Companies – subsidiaries of a combined group that provide insurance to the group in an arm's-length manner similar to that of a third-party insurer may be excluded from the combined group provided they qualify as a bona fide insurer (e.g., insurance companies that lawfully qualify as life insurance companies under section 816 of the Code, and life insurance companies subject to tax under section 831 of the Code). In some cases, taxpayers will use "captive insurance companies" for state tax minimization purposes. As a result, the actual status of such "captive insurance companies" must be carefully reviewed by the auditor to verify that the subsidiary is a

bona fide insurer and should rightfully be excluded from the combined group. Additional discussion regarding captive insurance companies and insurance and life insurance companies may be found in the FAPM in section [9.1.8 Insurance and Life insurance companies \(M.G.L. c. 63 §§ 20 through 29E\)](#)

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#### **10.4.2 Combined Group Member Inclusion or Exclusion - Auditor Tests and Checklist**

##### **Water's Edge Filing vs. Affiliated Group Election vs. Worldwide Election**

A water's edge filing is the "default" filing status on which a combined group determines taxable income and apportionment in a combined report (it is the "default" insofar as it represents a combined report where there is no valid group election in effect).

An affiliated group election also retains the water's edge filing status. A taxpayer that makes an affiliated group election generally does so to eliminate the requirement to determine what combined group members should be included or excluded under the unitary business standard (which is a requirement of a water's edge filing). As a result, the same tests and checklists an auditor may apply to a water's edge filing will generally apply under an affiliated group election (with some minor distinctions that will be specifically noted below).

Finally, while a worldwide election represents a distinct departure from a water's edge filing, it, too, may be evaluated by the auditor using the same tests and checklists (unless specifically noted otherwise).

With this approach in mind, corporations are includible in the combined group once the auditor verifies that they meet the following tests:

(1) The "Common Control" Test - the corporation being tested is under common ownership with the group, defined as one or more common owners directly or indirectly having greater than 50% voting control of the various corporations:

- ✓ In a chain of corporations, if a person has more than 50% of the voting control of an entity, it is considered to hold all of the voting control interests held by that entity (e.g., where A has 51% voting control of B which has 51% voting control of C, A is considered to have 51% voting control of C.)
- ✓ Unlike a federal consolidated return, the common owner of a combined group does not need to be part of the group and does not even need to be a corporation
- ✓ "Stapled entities" as described in [IRC § 269B](#) are treated as commonly owned

- ✓ Related persons aggregate their voting control. In determining whether or not a person is a related person, the constructive ownership rules of [IRC § 318](#) generally apply except that
  - (i) if a partnership, estate, trust or corporation owns, directly or indirectly, more than 50% of the voting control of a corporation, it shall be considered to own all of the stock or other ownership or control interests in such corporation (IRC § 318(a)(2)) and
  - (ii) if a person has an option to acquire stock or other ownership interests they shall be treated as owned by such person to such extent necessary to prevent tax avoidance  
See 830 CMR 63.32B.2(e).
- ✓ In determining common ownership, the commissioner may take into account any plan or arrangement for shifting ownership or voting control

See [10.4.8 Common Ownership - Checklist and Examples for more detailed discussion regarding the contours of this test.](#)

(2) The “Unitary Business” Test - the corporation being tested is engaged in a unitary business with the commonly owned corporations. The term “unitary business” is construed to the broadest extent permitted under the United States Constitution. A unitary business generally exists where there is a flow of value between the common business and the corporation:

- ✓ This test is not applicable if an affiliated group election has been made because such election eliminates application of the unitary business standard
- ✓ Where corporations under common control are engaged in the same general line of business they are likely to be engaged in a unitary business
- ✓ Where corporations under common control are engaged in steps of a vertically structured business they are likely to be engaged in a unitary business
- ✓ Newly-acquired entities are presumptively not unitary immediately after acquisition unless the newly-acquired corporation was previously in a position that would have suggested a unitary relationship if there had been common ownership (as described above)
- ✓ Newly-formed entities created by members of a combined group are presumed to be unitary with the corporations that created them
- ✓ A passive holding company is deemed to be unitary with its parent and with its subsidiaries
- ✓ Commonly owned corporations transferring or sharing of intellectual property between each other are likely engaged in a unitary business

- ✓ Commonly owned corporations participating in an intercompany financing arrangement with each other that serves an operational purpose are likely engaged in a unitary business

See Unitary Business subsections [10.4.4](#) through 10.4.7 below.

### (3) The “US Corporation” Test

- ✓ This test is not applicable if a worldwide election has been made (this is because a worldwide election generally includes both US and non-US corporations)
- ✓ the corporation being tested is incorporated in the United States or formed under the laws of the United States, any state, the District of Columbia or any territory or possession of the United States, or
- ✓ the corporation being tested has nexus with Massachusetts, or
- ✓ the average of its property, payroll and sales factors for the corporation being tested is 20% or more
- ✓ or the corporation being tested earns more than 20% of its gross income, directly or indirectly, from intangible property or service-related activities, the costs of which generally are deductible for federal income tax purposes

The auditor is expected to apply the above tests separately to each corporation considered for inclusion or exclusion unless it is specifically noted otherwise. *See generally* [830 CMR 63.32B.2\(3\)](#) and (4) for additional guidance on whether a corporation should be included in a combined report. As specifically noted above, a worldwide election dispenses with the US Corporation test, and an affiliated group election dispenses with the Unitary Business test. Otherwise, the above tests apply to determine composition of most combined groups.

Note: if a corporation is added to the group, business activities involving the newly included member and other corporations under common control may bring still other corporations into the group. Remember that a corporation should not be included as a member of the combined group if it fails to meet any one of these tests.

### **Sources of Information for Inclusion Testing**

The most likely source of information on a possible error or omission in determining the combined group (a list of corporations to be tested) is the taxpayer’s federal income tax return and its accompanying schedules and disclosures. If the taxpayer has filed a federal consolidated return, the federal consolidation schedules for lines 1 through 28 (or their computational equivalent) should be compared to the Schedules U-M filed with the Massachusetts combined report. Any discrepancies should be noted and addressed by the auditor.

### **Combined Member Inclusion or Exclusion – Information Checklist**

While not inclusive, the following information, however gleaned (e.g., from Massachusetts tax filings, federal returns or other sources), should be considered by the auditor when verifying combined member inclusion or exclusion (distinctions for cases where there is an affiliated group or worldwide election will be specifically noted):

- ✓ In the case of an affiliated group election, only corporations that are statutorily excluded (e.g., security corporations, insurance companies) should be excluded from the Massachusetts group. Auditors should therefore look for corporations with significant federal taxable income that may have been improperly excluded from the Massachusetts affiliated group
- ✓ A foreign corporation should typically be identified on Schedule U-M. A line item on the top of the schedule form should indicate if it is a non-US corporation (note also that a foreign corporation's FID may be missing or displayed as "99-9999999" on the form)
- ✓ The absence of a corporation from the list of entities on Schedule CIR may also indicate it is a non-US entity
- ✓ Certain large corporations are required to file Schedule M-3 with their U.S. tax return. Part 1 reconciles the income reported on their financial statements to the book income figure used as a base for calculating federal taxable income. Corporations filing Schedule M-3 must file Schedule NIR. A foreign subsidiary may be listed on Schedule NIR and should be reviewed for inclusion
- ✓ The auditor should review any other corporations or entities listed in schedule M-3, part 1, that are being added or excluded from the federal filing. Corporations, particularly US corporations with significant net income should be scrutinized. The standard for inclusion in the federal consolidated return is 80% of vote and value, which is a much higher threshold than the greater than 50% of voting stock required for a Massachusetts combined group
- ✓ Schedule M-3 will also list entities not included in the financial statements that are added to the federal consolidated return. Entities with significant losses should be reviewed, and if they are engaged in a unitary business with the taxpayer the perceived inconsistency should be explained by the taxpayer.
- ✓ If the taxpayer filing schedule M-3 (the common parent for federal purposes) is not a public company, request information on the identities of any shareholders owning 25% or more of the stock of the common parent
- ✓ Review other deductions for evidence of royalty payments – if significant royalty payments are made to a related entity outside the group there may be an adjustment to be made or this may be an addback issue.

- ✓ When reviewing a return where a worldwide election was NOT made, and either the inclusion of a foreign member or the amount of its income and deductions for the combined report as shown on schedule U-M is in question, the first request to the taxpayer should usually be for a copy of the foreign corporation's federal tax return with an explanation of the taxpayer's basis for including the member (i.e., what inclusion rule applies under these circumstances)
- ✓ A foreign corporation may be required to file a US Form 1120F and pay tax to the US Treasury and still be excluded from the Massachusetts combined group if it fails to meet one of the specific statutory inclusion tests. If the foreign corporation is properly included in the combined group and (in the context of the combined filing) claims certain deductions, then those claimed deductions must be related to the income included in the combined report
- ✓ In the case of Fixed, Determinable, Annual or Periodic (FDAP) income (where tax is typically withheld by the payor since the foreign corporation generally does not file a federal return and is prohibited from claiming federal deductions from its US tax base because the tax is imposed on a gross receipts basis), the taxpayer should substantiate the basis for asserting that its claimed state deductions are related to such FDAP income
- ✓ Auditors should look for corporations with significant losses in the federal consolidation schedules, especially when those losses relate to "other income" or to items that appear inconsistent with the group's other reported income and deductions (e.g., where there is a large amount reported in "other deductions" for an entity that has little income). Each corporation that is a member of the combined group contributes its income and deductions to the combined group's calculation of net income, from which each taxable member takes its apportioned share. By including corporations with significant losses, the combined net income (and therefore the income measure of excise for each taxable member) is reduced such that disallowing a loss effectively increases combined group income
- ✓ Consider whether one or more corporations with large non-Massachusetts apportionment factors should actually be included in the combined group. Each taxable and non-taxable member contributes its property, payroll and sales to the apportionment factor denominators, which the non-taxable members then use to determine their apportioned income. By including corporations with large non-Massachusetts factors, the apportioned income of taxable members is decreased
- ✓ Where no affiliated group election has been made, corporations included in the combined filing that are not in the federal consolidated return should be noted, and both common ownership and a unitary relationship should be verified. If common ownership is not through a group member, both the reason for the exclusion and the possible existence of other affiliates related through the common owner should be verified

- ✓ A disclosure that the taxpayer has formed a new subsidiary that is not part of the combined group (including a non-US corporation) should be investigated; depending on the nature of the property transferred, there may be audit issues other than combined group membership that need to be addressed by the auditor
- ✓ Negative amounts on the income/deductions portion of the return that are not eliminated in a federal consolidated filing or a MA combined report should be reviewed. The most likely reason for entering a negative interest expense or a negative entry in “other deductions” is for it to be claimed by a related party, as in a cost-sharing arrangement. Negative amounts in accounts on the MA balance sheet should be investigated as they could be an indication that the taxpayer is using incorrect figures in order to make the total assets match with the liabilities/owner’s equity.
- ✓ IRS Form 5471 is sometimes filed with respect to a controlled foreign corporation. To the extent the federal return includes schedules for form 5471 showing intercompany transactions, this may support an inquiry about the 20% of gross income or 20% average factors analysis (i.e., as those tests are applied for purposes of determining whether a non-US corporation should be included in a water’s edge combined group)
- ✓ IRS Form 5472 is filed with respect to either a 25% foreign-owned U.S. corporation or a foreign corporation that is engaged in a trade or business within the United States. To the extent that the 2<sup>nd</sup> page of the form reports intercompany transactions, this may support inclusion of the foreign entity in a water’s edge combined group or, alternatively, could lead to a separate transfer pricing issue
- ✓ Review the combined report for evidence of commonly owned businesses that have not been included in such report. Evaluate any related member that is asserted to be outside the combined group that is claiming a deduction through schedule ABI or ABIE. Verify whether such related member should be included in the combined group. If the related member is foreign, request copies of any Schedules 1042 and/or 1042-S that may have been filed
- ✓ Review the financial statements issued by the taxpayer to shareholders, including the accompanying notes. Identify any affiliated corporation whether or not its activities are consolidated with the taxpayer’s in those financial statements. Request additional information from the taxpayer regarding any such affiliated corporation in order to verify its status in relation to the combined group
- ✓ Review the Massachusetts Secretary of State’s database which allows a search for corporate officers and directors. A corporation with several officers in common with the taxpayer being audited may be found to meet the requirements for inclusion in the combined report

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### 10.4.3 Corporate Combined Reporting Group Nexus - Checklist

Before a state may impose a tax there must be a sufficient connection, or “nexus,” between the state and the person or entity it proposes to subject to tax. A state may tax an out-of-state corporation on an apportionable share of its interstate business provided there is such minimal connection or nexus between its interstate activities and the taxing state. *General Mills, Inc. v. Commissioner*, 440 Mass. 154, 161 (2003). The reason for this is to abide by the principles derived from the Commerce Clause and the Due Process Clause of the U.S. Constitution. *Id.* Nexus is a threshold requirement for combined reporting and continues to be determined for each corporation separately. The auditor must make a nexus determination in the same manner when evaluating a single corporation that would file on a stand-alone basis and in the context of a corporate member of a combined group, in the latter instance making the determination for each separate member of the group. Section [9.5 Corporate Nexus](#) provides detailed discussion and instruction regarding nexus determinations for stand-alone corporations. Auditors should refer to this section when making a nexus determination for each member.

#### **Combined Group Nexus Determination - Checklist**

A few additional rules and principles that apply to combined group nexus determinations are set forth in the following checklist:

- ✓ a combined report is required even if only one member of the group has nexus with Massachusetts. Where one corporation that is engaged in a unitary business has nexus in Massachusetts, the requirement of combined reporting is triggered (so long as one or more of the other corporations engaged in the unitary business is subject to combined reporting), which then operates to reach the taxable net income of the entire unitary business
- ✓ a non-US corporation with nexus in Massachusetts is included in a default “water’s edge” combined report if it is under common control with one or more other corporations and is engaged in a unitary business with such corporations
- ✓ a corporation with nexus in Massachusetts that is part of a combined group is required to file as a taxable member of such group. See [10.2.4 Taxable and Non-Taxable Combined Group Members](#). It must also determine and pay tax on the non-income measure of excise if it is statutorily required to do so.
- ✓ Where a corporation is asserting the protections of Public Law 86-272 as its basis for not reporting and paying the income measure of excise to Massachusetts, it is still required to compute and pay a non-income measure of excise or the minimum excise due (whichever is greater) if it is statutorily required to do so.

- ✓ Whether a combined group member is a taxable or non-taxable member impacts the determination of the *Finnegan* rule regarding sales of non-taxable members that are attributed to taxable members. See [10.7.5 Combined Group Income Apportionment - Special Rules](#).

#### **10.4.4 Unitary Business – Tests for Unity**

As a general rule, the commerce clause and the due process clause of the United States Constitution prohibit a state from imposing a tax on value earned outside of its borders (i.e., “extraterritorial values”). See, e.g., *General Mills, Inc. v. Commissioner*, 440 Mass. 154, 161 (2003); *ASARCO Inc. v. Idaho State Tax Commission*, 458 U.S. 307, 315 (1982).

Under the unitary business principle, a state may impose a tax on an out-of-state corporation on an apportioned share of its interstate business provided:

(1) there is a minimal connection (i.e., nexus) between its interstate activities and the state; and  
(2) there is a rational relationship between the income attributed to the state and the intrastate values of the business enterprise

*General Mills*, 440 Mass. at 161. The unitary business principle permits the state to tax income received by an out of state corporation from its subsidiary, even if the subsidiary does not do business in the taxing state, provided such tax is attributable to the subsidiary's operational involvement in the out of state corporation's interstate business that is subject to tax by the state. *Id.* at 162.

#### **Massachusetts Test for Unitary Business**

Under the MA combined reporting statute, a “unitary business” is defined as:

[T]he activities of a group of two or more corporations under common ownership that are sufficiently interdependent, integrated or interrelated through their activities so as to provide mutual benefit and produce a significant sharing or exchange of value among them or a significant flow of value between the separate parts.

M.G.L. c. 63, § 32B. The combined reporting regulation instructs that “[t]he term unitary business shall be construed to the broadest extent permitted under the United States Constitution.” 830 CMR 63.32B.2(2). In addition, the combined reporting regulation sets forth certain rebuttable presumptions and inferences concerning whether and when two or more corporations under common ownership will be deemed to be engaged in a unitary business. [830 CMR 63.32B.2\(3\)\(a\)](#).

Numerous state and federal cases have addressed the constitutional limits of what can be considered a unitary business. In Massachusetts, auditors must consider the rebuttable presumptions in the combined reporting regulation and the relevant statutory definition in light of the various constitutional tests in order to determine the existence of a unitary business. Auditors must also familiarize themselves with other states’ unitary business case law doctrines which have been adopted by Massachusetts.

#### **10.4.5 Unitary Business – State and Federal Case law Background**

While not directly controlling, the following are some major cases of which auditors should be aware of in order to better understand the constitutional limits of the unitary business requirement.

##### **Development of the Unitary Business Principle**

Development of the unitary business principle can be traced through 19<sup>th</sup> Century U.S. Supreme Court decisions, including cases which approved a method of “unit” taxation of railways (*Union Pacific Railway Co. v. Ryan*, 113 U.S. 516 (1884)) and multistate businesses (*Adams Express Co. v. Ohio*, 165 U.S. 194 (1897)). The principle was then later applied to uphold use of a formulaic income apportionment method on a single corporation engaged in multi-state business activities (*Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113 (1920)).

In *Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission*, 266 U.S. 271 (1924), the U.S. Supreme Court expressly approved application of the unitary business principle to the worldwide business activities of a single corporation. In *Bass* the Court held that a state was justified in attributing a portion of the profits earned by a corporation that carried on a global business of manufacturing and selling a product where the profits were earned from transactions beginning with non-US manufacturing and ending with sales into the US and other locations (where the profits were not earned until the sales occurred).

##### **Unitary Business – “Three Unities” Test**

In *Butler Bros. v. McColgan*, 315 U.S. 501 (1942), the U.S. Supreme Court upheld the California Supreme Court’s application of a “three unities” test for determining a unitary business when the presence of the following circumstances were established:

- (1) Unity of ownership;
- (2) Unity of operation (as evidenced by central purchasing, advertising, accounting and management divisions); and
- (3) Unity of use (in centralized executive force and general system of operations).

The test is satisfied when all three of the unities are present in the taxpayer’s business operations.

The California Supreme Court opinion (which was subsequently affirmed by the U.S. Supreme Court) noted that “the unitary nature of appellant’s business is established by the presence of the following circumstances: (1) Unity of ownership; (2) Unity of operation as evidenced by central purchasing, advertising, accounting and management divisions; and (3) Unity of use in its centralized executive force and general system of operations.” *Butler Bros. v. McColgan*, 17 Cal.2d 664, 678 (1941), *affirmed*, 315 U.S. 501 (1942).

##### **Unitary Business – “Contribution or Dependency” Test**

In *Edison California Stores v. McColgan*, 30 Cal.2d 472 (1947), the California Supreme Court formulated a “contribution or dependency” test in which a business will be considered unitary if its operations within a state “contribute to or are dependent upon” business operations outside of the state. Conversely, if there is no such contribution or dependency, the business within the

state may be considered to be separate and non-unitary with the business operations outside of the state.

In addition to formulating the “contribution or dependency” test, the court in *Edison* was the first to extend the unitary business principle to multiple entities where business activity was carried on by a group of separate corporations rather than by divisions of a single corporation. In *Edison*, California successfully argued that the unitary business principle applied to a business conducted through separate corporate affiliates and extends throughout a combined unitary business enterprise.

The “three unities” and “contribution or dependency” tests are still in force in many states as part of a comprehensive method to analyze and assess the presence of a unitary business. *See, e.g., California FTB Notice 1992-4* (stated policy is that the three unities test, contribution or dependency test and the other relevant constitutional tests apply with equal force and that a finding of unity will result if any one of the tests has been met).

#### **Appeals of Monsanto – Unity from Indirect Relationship**

In *Appeals of Monsanto Company*, 70-SBE-038 (November 6, 1970), the California State Board of Equalization determined that the unitary business principle does not require that the state establish that every activity conducted outside the state has some direct relation to an in-state activity. The *Appeals of Monsanto* decision rejects the argument that the unitary business principle does not apply to a corporation that does not “depend on or contribute to” another corporation that is doing business in the state. That argument was rejected because it misconstrued the unitary business principle, since all that is necessary is that the out-of-state corporation forms an inseparable part of the business wherever it is conducted.

*See also Barclay's Bank v. Franchise Tax Board*, 512 U.S. 298 (1994) (determination of unitary relationship between corporations included in a combined report may be established indirectly).

**Note:** Auditors should note that the doctrine in the *Appeals of Monsanto* in California that unity may be established indirectly is also applicable in Massachusetts. While nothing in the Department’s guidance expressly states as much, Massachusetts statutory law requires that the unitary principle must be construed to the fullest extent permitted under the U.S. Constitution. *See M.G.L. c. 63 § 32B(b)(1)* (“The term unitary business shall be construed to the broadest extent permitted under the United States Constitution”). In addition, the Department has issued internal guidance indicating this is how we should properly construe the law in Massachusetts.

#### **Unitary Business – “Constitutional” Test**

The “three unities” and the “contribution or dependency” tests were prevailing methods of determining the presence of a unitary business until the early 1980s, when the U.S. Supreme Court formulated another test to apply when determining whether a unitary business exists.

This “constitutional” test analyzes whether components of a business operation exhibit contributions to income resulting from the following “profitability factors” which arise from the operation of the business as a whole:

- (1) functional integration;
- (2) centralization of management; and
- (3) economies of scale;

where such contributions are evidenced by a flow of value (not necessarily a flow of goods) between the components of the business operation.

*See Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425 (1980); *Exxon Corp. v. Wisconsin Dept. of Revenue*, 447 U.S. 207 (1980); *F.W. Woolworth Co. v. Taxation and Revenue Dept. of the State of N.M.*, 458 U.S. 354 (1982); *Container Corp. v. Franchise Tax Board*, 463 U.S. 159 (1983). In *Mobil Oil Corp.*, the US Supreme Court addressed the constitutional limits of a non-domiciliary state's taxation of dividend income received by a US corporation from its non-US subsidiaries and affiliates. Recognizing that the “linchpin of apportionability in the field of state income taxation is the unitary business principle,” the Court formulated the above constitutional test to apply when determining whether a unitary business exists. In so holding, the US Supreme Court articulated an “economic realities” principle that stressed the importance of looking at the underlying economic realities of an overall business relationship (not the form of business organization) in order to determine the propriety of state income apportionability.

In *Container Corp. v. Franchise Tax Board*, 463 U.S. 159 (1983), the US Supreme Court applied the constitutional test profitability factors and upheld application of the unitary business principle to multiple corporations, where business activity was carried on by a group of separate corporations rather than by divisions of a single corporation. This issue was previously addressed and approved by a state supreme court (California) in the *Edison California Stores v. McColgan* case (*see above*).

In *Container*, the U.S. Supreme Court also addressed whether unitary business income and “passive investment” income of non-US subsidiary corporations can be subject to fair apportionment by a state. The Court reiterated the principle that the unitary business income of a corporation doing business in a state can be subject to fair apportionment. However, in addressing “passive investment” income of non-US subsidiary corporations, the Court noted that where a corporation has non-business passive investment income it can only be taxed by the state where such corporation has its commercial domicile.

### **Unitary Business - Massachusetts Cases**

In *General Mills, Inc. v. Commissioner*, 440 Mass. 154 (2003), a case decided several years prior to mandatory combined reporting, the Massachusetts Supreme Judicial Court applied the constitutional test factors (i.e., functional integration, centralized management and economies of scale) established by the US Supreme Court (*see above*): “[t]he test used to determine the existence of a unitary business relationship between a corporation and its subsidiary for purposes of assessing an apportionable tax focuses on whether ‘contributions to income result[] from functional integration, centralization of management, and economies of scale.’” *General*

*Mills*, 440 Mass. at 162 (quoting *Mobil Oil Corp. v. Commissioner of Taxes*, *supra*, 445 U.S. at 438).

In *General Mills*, the SJC applied the U.S. Supreme Court's determination in *Container* that transactions that serve a non-operational passive investment function result in non-unitary business income. *General Mills, Inc.*, 440 Mass. at 165.

The MA Appeals Court followed the same rationale in *W.R. Grace & Co. v. Commissioner*, 58 Mass. App. Ct. 469 (2003), in applying the profitability factors of this constitutional test.

### **Unitary Business – Audit Case Development**

A unitary analysis must be based on evidence that the auditor develops from the specific facts and circumstances of the case under review. Mere conclusions from the auditor without more (such as "the taxpayer had strong centralized management" or "both companies are in the same kind of business") will not hold up to legal review without adequate substantiation to support such conclusions.

The auditor must address the unitary business issue by applying the established tests to the unique facts and circumstances of each case. As mentioned earlier, while the unitary business presumptions stated in the Massachusetts regulation are important, they are merely presumptions and are not conclusive for determining unity. These presumptions may be rebutted by the taxpayer or the commissioner.

In each separate audit case, the auditor should start by applying the statutory test and the relevant unitary business presumptions and then build upon that foundation through application of relevant Massachusetts SJC, U.S. Supreme Court and other state supreme court decisions. In some instances, other Massachusetts court and ATB decisions may be helpful. In all cases auditors should recall that the unitary standard is an intensely factual one, and that each set of facts must be evaluated on its own terms. As the U.S. Supreme Court noted in the *Container* case: "A final point that needs to be made about the unitary business concept is that it is not, so to speak, unitary: there are variations on the theme, and any number of them are logically consistent with the underlying principles motivating the approach." *Container*, 463 U.S. at 167-68.

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### **10.4.6 Unitary Business - Presumptions and Inferences**

The combined reporting regulation sets forth certain presumptions and inferences concerning whether and when two or more corporations under common ownership will be deemed to be engaged in a unitary business. [830 CMR 63.32B.2\(3\)\(a\)](#). This portion of the regulation does not purport to set forth all the indicia of a unitary business, as that determination is to be made pursuant to U.S. Constitutional principles. See [830 CMR 63.32B.2\(2\) and section 10.4.5 Unitary Business – State and Federal Caselaw](#). While the unitary business presumptions stated in the combined reporting regulation are important, it must not be forgotten that they are merely presumptions and are not conclusive for determining unity. These presumptions may be

rebutted by the taxpayer or the commissioner.

As a result, the auditor should start by applying the specific language of the Massachusetts statute (M.G.L. c. 63, § 32B – see [10.4.4 Unitary Business – Tests for Unity](#) above) which sets forth a test that has been crafted with decided MA Supreme Court cases and the California unitary standard in mind. The U.S. Supreme Court cases should also be considered (see [10.4.5 Unitary Business – State and Federal Caselaw Background](#) above). In some instances, Massachusetts court and ATB decisions may also be helpful. However, in all cases, auditors should consider that the unitary standard is an intensely factual one and that each set of facts and circumstances must be evaluated on its own terms.

**Note:** Auditors must remember that these presumptions and inferences do not apply when there is a valid affiliated group election, since the affiliated group composition does not depend upon the unitary business standard (but rather looks to the common ownership standard).

### **Unitary Business Presumptions and Inferences - Checklist**

The combined reporting regulation at [830 CMR 63.32B.2\(3\)](#)(b) through (3)(f) provides the following unitary business presumptions and inferences to assist the auditor in making a unitary business determination:

- ✓ Inference from Likely Unitary Situations - business activities conducted by corporations under common ownership in the same general line of business (such as a multistate grocery chain) will generally constitute a unitary business. Business activities conducted by corporations under common ownership that comprise different steps in a vertically structured business will almost always constitute a unitary business. [830 CMR 63.32B.2\(3\)\(b\)](#)
    - Example* - a business engaged in the exploration, development, extraction, and processing of a natural resource and the subsequent sale of a product based upon the extracted natural resource is engaged in a single unitary business
  - ✓ Presumptions from Newly-acquired and Newly-formed Entities (“Instant Unity”) – certain transactions involving newly-acquired and newly-formed entities create presumptions that may be rebutted by the taxpayer or the Commissioner by presenting clear and cogent evidence showing that the corporations in question either are (or are not) engaged in a unitary business. The following rebuttable presumptions should be evaluated by the auditor when such circumstances are present:
    - 1) Newly-formed entities are presumed to be unitary upon formation (“Instant Unity”);
    - 2) Newly-acquired entities are presumed to not be unitary for their first combined reporting period unless they are engaged in a relationship that would have been considered unitary but for lack of common ownership (e.g., same line of business, vertical integration)
- See [830 CMR 63.32B.2\(3\)](#)(c)1. and (c)2.

A case example for auditors to consider in reviewing the instant unity issue is *In re Appeal of Atlas Hotels*, Cal. BOE 85-SBE-001 (1984). In *Atlas Hotels*, the CA Franchise Tax Board determined that a parent and subsidiary were unitary upon the date of subsidiary's acquisition where the parent immediately (1) placed two of its top executives to run subsidiary's day-to-day operations, (2) made numerous operational changes to subsidiary's administrative and purchasing functions and (3) arranged subsidiary's financing by guaranteeing loans.

- ✓ Passive Holding Companies Deemed to be Engaged in Unitary Business - A passive parent holding company that directly or indirectly controls one or more operating company subsidiaries engaged in a unitary business shall be deemed to be engaged in a unitary business and includable in a combined report with the subsidiary or subsidiaries. An intermediate passive holding company shall also be deemed to be engaged in a unitary business with the parent and subsidiary or subsidiaries and includable in a combined report with them. See [830 CMR 63.32B.2\(3\)](#)(d).
- ✓ Sharing of Intellectual Property; Intercompany Financing – Evidence or indicia of a unitary relationship exists where there is significant:
  - (1) transfers or sharing of technical information or intellectual property (such as patents, copyrights, trademarks and service marks, trade secrets, processes or formulas, know-how, research or development);
  - (2) common or intercompany financing (including the guarantee by, or the pledging of the credit of, one or more business entities for the benefit of another business entity or entities), if such financing activity serves an operational purpose.

See [830 CMR 63.32B.2\(3\)](#)(e).

- ✓ Relevance of Market-based or “Arm’s Length” Pricing to Intercompany Transactions – an indicia of a unitary business is sales, exchanges, or transfers of products, services and/or intangibles conducted between or among corporations related by common ownership. If such evidence exists it is not negated by use of market-based or “arm’s length” pricing. See [830 CMR 63.32B.2\(3\)](#)(f).

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#### **10.4.7 Unitary Business – Partnerships**

Under the “aggregate theory” of partnership taxation, a partnership does not have a separate legal existence like a corporation and as such it is not taxed at the entity level.

The definition of unitary business in 830 CMR 63.32B.2(2) of the combined reporting regulation treats a business conducted through a partnership as the business of the partners, regardless of the magnitude of the partner's ownership interest. This applies whether the partnership interest

is owned directly or through a series (chain) of partnerships. If the business conducted through the partnership is unitary with the common business of the combined group, the partner's distributive share of the partnership's unitary business income is includible in the combined group's net income subject to apportionment. The corporation's pro-rata share of the partnership's related unitary business factors also "flow up" to and are included in the apportionment of the combined group's net income.

### **Unitary Business – Partnerships Checklist**

Auditors should consider the following principles when applying the rules of 830 CMR 63.38.1(2) to an audit involving a partnership:

- ✓ Verify that the entity is not a corporation for US classification purposes. Hybrid entities are classified based upon their Federal tax classification
- ✓ Partnership factors are modified to reflect the partnership's transactions with any member of the group if the transactions relate to the unitary business (i.e., the same elimination principle that applies as between corporate members of the combined group will apply). The auditor should determine what transactions are made by the partnership to unrelated 3rd parties or any affiliates that are outside the Massachusetts combined group
- ✓ If all of the partnership's sales are made to group members as part of the unitary business, none of these sales will be included in the sales factor numerator or denominator. If the partnership makes sales to unrelated 3rd parties, and those sales are in Massachusetts, the sales will be included in the sales factor numerator of the corporation that owns the partnership interest, in proportion to the corporation's ownership interest. This pro rata concept only applies where the corporation's ownership interest is less than 100%
- ✓ Where the partnership rents property those rents will be treated as having been paid directly to the corporate owner

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### **10.4.8 Common Ownership - Checklist and Examples**

For two or more corporations to be subject to combined reporting they must be engaged in a unitary business and must be under common ownership.

The common ownership standard requires that more than 50% of the voting control of each member is directly or indirectly owned by a common owner or owners subject to specific rules and examples set forth in the combined reporting regulation. [830 CMR 63.32B.2\(2\)](#). It is not necessary that the owner be a member of the group (i.e., the standard is met if an individual owns more than 50% of the voting stock in each of 2 corporations).

The auditor must therefore verify that each member of the combined group meets the common ownership standard. If not, such member(s) must be excluded from the combined group. Conversely, if the auditor determines that one or more corporations meet the common ownership standard (as well as the other combined reporting requirements) such corporations

must be added as member(s) of the combined group.

**Common Ownership - Checklist**

The following should be considered by the auditor when evaluating whether one or more reported or potential combined group members meet the requirements of the common ownership standard:

- ✓ Direct and Indirect Voting Control and Tiered Ownership - if the same person or related persons hold directly or indirectly more than 50% of the voting control of a corporation (“parent corporation”), then those persons shall be considered to hold indirectly any stock or other interest in ownership or control in a lower-tier corporation (“subsidiary corporation”) that is directly or indirectly held by the parent corporation. [830 CMR 63.32B.2\(2\)\(a\)](#). Auditors should refer to Examples 1 and 2 of the regulation for illustration of this rule
  
- ✓ Related Versus Unrelated Owners:
  - ⇒ Related Owners - two or more corporations (where stock representing more than 50% of the voting control of each corporation is owned directly or indirectly by the same person or related persons), whether corporate or non-corporate, are treated as commonly owned or under common ownership and subject to inclusion in a combined group. A common owner or such common owners need not be members of the combined group. [830 CMR 63.32B.2\(2\)\(b\)\(1.\)](#). Auditors should refer to Examples 3 and 4 of the regulation for illustration of this rule
  
  - ⇒ Unrelated Owners - Two or more corporations shall not be treated as commonly owned or under common ownership, and subject to inclusion in a combined group, solely because such corporations have one or more unrelated owners in common, where aggregation of the ownership of such unrelated owners would be necessary in order to represent more than 50% of the voting control of any of such corporations. [830 CMR 63.32B.2\(2\)\(b\)\(1.\)](#). Auditors should refer to Example 5 of the regulation for illustration of this rule
  
- ✓ Stapled Entities - two or more corporations that are "stapled entities" as described in [IRC § 269B](#) are treated as commonly owned or under common ownership and subject to inclusion in a combined group. Stapled entities are entities where, by reason of their form of ownership, or restrictions on transfer of ownership, or other terms or conditions (whether existing by operation of law, by written contract, or otherwise), in the case of a transfer of one or more ownership interests, more than 50% of the voting control of each entity is required to be transferred. [830 CMR 63.32B.2\(2\)\(c\)](#)

- ✓ More than One Unitary business - a group of corporations under common ownership may be engaged in one or more unitary businesses. Auditors should refer to [830 CMR 63.32B.2\(2\)\(d\)](#) Example 6 for illustration of this potential situation
- ✓ Related Parties; Constructive Ownership - in determining whether a person is a related person or is considered to hold stock or other ownership or control interests in an entity that is directly held by another person, the constructive ownership rules described in [Code § 318](#) shall generally apply, to the extent not inconsistent with the rules or requirements described in the definition of common ownership or elsewhere in 830 CMR 63.32B.2, except that:

1. in applying Code § 318(a)(2), if a partnership, estate, trust or corporation owns, directly or indirectly, more than 50% of the voting control of a corporation, it shall be considered to own all of the stock or other ownership or control interests in such corporation, and
2. if a person has an option to acquire stock or other ownership interests in an entity, such stock or other ownership interests shall be treated as owned by such person only to such extent as determined by the Commissioner as necessary to prevent tax avoidance.

[830 CMR 63.32B.2\(2\)\(e\)](#)

Example - Application of IRC Section 318 Constructive Ownership Rules:

- 1) If two corporations are wholly-owned between husband and wife there is common ownership;
  - 2) If the corporations are wholly-owned between a brother and sister there is no common ownership
- ✓ Ownership or Voting Control Plans or Arrangements. In determining common ownership, the Commissioner may take into account any plan or arrangement, whether existing by operation of law, by contract, or otherwise, for bestowing or shifting ownership or voting control, in addition to the terms of any actual stock ownership or control. [830 CMR 63.32B.2\(2\)\(f\)](#)
  - ✓ Partners and Partnership Interests. The common ownership rules in 830 CMR 63.32B.2(2) are subject to the rules addressing partners and partnership interests that are described in 830 CMR 63.32B.2(2)(Unitary Business) or the rules set forth elsewhere in 830 CMR 63.32B.2. [830 CMR 63.32B.2\(2\)\(g\)](#)

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## 10.5 Water's Edge or Worldwide Parameters of Combined Reporting

Regardless of its place of incorporation or formation, a corporation is required to file a combined report when it is subject to tax under M.G.L. c. 63, § 2, 2B, 32D, 39 or 52A and is engaged in a unitary business with one or more corporations related by common ownership. See [10.2.2 Combination under M.G.L. c. 63 Section 32B](#).

As earlier mentioned, a taxpayer may elect to determine the apportioned share of the aggregate taxable net income or loss derived from the combined group's unitary business pursuant to a worldwide election under which each taxable member takes into account the income and apportionment factors of all the members, wherever located, that are includible in the combined group. If the taxable members of a combined group do not make a worldwide election, each taxable member must determine its apportioned share of such income on a water's edge basis.

Note: an affiliate group election (the alternative voluntary combined group election) is subject to the default water's edge filing requirement, albeit with the added characteristic of not being subject to review under the unitary business standard. See [10.2.3 Corporate Combined Reporting - Group Election Options](#) and [10.10 Massachusetts Affiliated Group Election](#). As such, an affiliated group election is more of an outgrowth of a water's edge filing than a departure from it (as in the case of a worldwide election). Accordingly, an affiliate group election is subject to most of the water's edge rules and requirements relating to income and apportionment, among other things, with some minor differences that will be specifically noted.

### 10.5.1 General Rule-Income Determination on Water's Edge Basis (830 CMR 63.32B.2(5)(a))

Taxable members of a combined group engaged in a unitary business may elect to determine their apportioned share of the aggregate taxable net income or loss derived from the unitary business pursuant to a worldwide election. [830 CMR 63B.2\(5\)\(a\)](#). Under this election, each taxable member must take into account the income and apportionment factors of all the members (wherever located) that are includible in the combined group.

### 10.5.2 Default Rules-Water's Edge Unitary Group (830 CMR 63.32B.2(5)(b))

If the taxable members of a combined group do not make a worldwide election, each taxable member determines its apportioned share of such income on a water's edge basis. This statutory water's edge filing requirement is imposed by default when a worldwide election is not in effect. [830 CMR 63B.2\(5\)\(b\)](#).

Corporations incorporated in the United States, or formed under the laws of the United States, any state, the District of Columbia or in any territory or possession of the United States, are includible as a member of the water's edge filing group if they meet both the common control and unitary business requirements and are otherwise includible (see [10.2 Overview of Corporate Combined Reporting](#)). These corporations determine gross income and deductions on a worldwide basis under the Internal Revenue Code and exclude income only if it is not part of the unitary business.

### **Water's Edge Filing – Status of Foreign Corporations**

Auditors must evaluate the status of foreign corporations under a water's edge filing. Foreign (non-U.S.) corporations are not subject to combination in a water's edge filing unless they:

- (1) meet both the common control and unitary business standards; and
- (2) any of the following of a) through c) apply:

- a) The non-U.S. corporation is itself taxable in Massachusetts (note that such corporations, as included within the combined report, will then use M.G.L. c. 63 § 32B to determine their taxable net income). The licensing of intangible property for use in the Commonwealth will generally trigger this requirement. See [Directive 96-2](#).

In such a case, the non-U.S. corporation's federal gross income (the amounts potentially includible in a combined report) is generally limited to income effectively connected with a trade or business in the United States plus any U.S. Source income (this may be further limited by application of a tax treaty). See [TIR 10-16: Non-U.S. Corporation with U.S. Income Exempt from U.S. Tax Pursuant to a Bilateral U.S. Income Tax Treaty](#).

- b) The non-U.S. corporation's separately determined property, payroll and sales apportionment factors average 20% or more (for this purpose, "factors" are the amount of property, payroll or sales in the United States over the worldwide amount).

In these cases, again, federal gross income is determined under the Code and applicable treaties. Note that a foreign corporation that sources 60% of its receipts to the United States will meet this threshold. See the detailed rules pertaining to this requirement set forth at 830 CMR 63.32B.2(5)(b)(2).

- c) The non-U.S. corporation earns 20% of its gross income directly or indirectly from intangible property or service related activities (including lending) the costs of which generally are deductible by other members of the group for U.S. income tax purposes, either currently or over a period of time.

In this scenario, only the federal gross income that the corporation receives from such intangible property or services and the factors related to that income are includible in the combined group's tax computation. Furthermore, under [830 CMR 63B.2\(5\)\(b\)\(3\)](#), the income of the foreign corporation that is included in the combined group's computation is reduced by expenses reasonably related and not disproportionate to the included income (but not to an amount below zero).

Income not included because not federal gross income still remains subject to the add-back provisions of M.G.L. c. 63 sections 31I through 31K. See the detailed rules pertaining to this requirement set forth at 830 CMR 63.32B.2(5)(b)(3).

**Note:** Auditors must keep in mind that the threshold requirements for filing a combined report still apply and must be verified before the validity of (or consequences arising from) any combined group election is evaluated:

Example: two corporations that are not engaged in a unitary business cannot elect to be treated as an affiliated group so that they may share losses or convert allocable income to apportionable income. Conversely, if the two corporations are required to file a combined report (and are otherwise eligible) they can elect to be treated as an affiliated group the consequence of which might be, among other things, to share losses or convert allocable to apportionable income.

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### **10.5.3 Mechanics for Making a Worldwide Election (830 CMR 63.32B.2(5)(c))**

A worldwide election must be made by the principal reporting corporation of the combined group or by a member that is specifically designated by the commissioner. See [Directive 15-2: Approval of Principal Reporting Corporation](#) (directing that commissioner has authority to approve designation of a member that is not an entity specifically designated by the regulation).

#### **Validity of Worldwide Election**

Auditors must verify that the election has been made on an original timely filed return (or as otherwise required in writing by the commissioner). Any original return which is not timely filed (whether filed with an application for abatement or otherwise) does not constitute a valid worldwide election. As a result, if the year under audit represents the first year of the election, it will be invalid for that year and any subsequent effective tax year unless and until the taxpayer has correctly made the election on a subsequent original timely filed return.

#### **Effect of Worldwide Election in Subsequent Tax Years**

Auditors must review the status of a valid worldwide election to verify it is still binding and in effect for the year under audit. A valid worldwide election is effective for the taxable year it is made and for the next nine taxable years thereafter. The election may be renewed after ten taxable years for another ten taxable years in the same manner in which the original election was made. When a prior worldwide election is neither affirmatively revoked nor renewed after ten taxable years it will terminate for the subsequent taxable year. The combined group may make a new worldwide election for any ten-year period thereafter in the same manner in which the original election was made.

#### **Worldwide Election – Composition; Change in Reporting Method**

The auditor must also review the worldwide group election in situations where a corporation enters the combined group after the first year of the worldwide election. Generally entry by a corporation in this manner is deemed to constitute a consent to and waiver of any objections to the worldwide election. When entry is a result of a merger or acquisition, auditors may be required to apply the reverse acquisition rules based on the federal rules in [U.S. Treas. Reg. § 1.1502-75\(d\)\(3\)](#) to verify that a corporation entering the group is bound by the worldwide election.

When a combined group makes a current tax year worldwide group election or an existing worldwide group election terminates, a change in reporting method results which must be addressed by the reporting taxpayer and verified by the auditor. If either the water's edge or worldwide method was used to account for the combined group members' income and apportionment data in the preceding tax year, and the other method is used for the current tax year, the income and apportionment amounts for combined group members must be adjusted to prevent them from being omitted, duplicated or otherwise distorted. See 830 CMR 63.32B.2(5)(c)(3).

#### **Worldwide Election – Interaction with Affiliated Group Election**

A taxpayer may not make a worldwide election and an affiliated group election for the same taxable year and may not make a worldwide election for any year in which an affiliated group election is in effect. See 830 CMR 63.32B.2(10). Auditors must thus ensure that the proper election, if any, is in effect for the tax year under audit and the correct rules and requirements related to such election are applied.

#### **Worldwide Election – Taxpayer Consent to Production of Documents**

A worldwide election constitutes consent by the taxpayer to the production of documents or other information that the Commissioner reasonably requires. See 830 CMR 63.32B.2(5)(c)(6). Auditors must be mindful of this provision when they encounter difficulty in obtaining required documentary evidence.

Example – An auditor can require production of documents or other information that the Commissioner reasonably requires for purposes of verifying the appropriate members of the combined group, that the requirements of the worldwide election have been met, that the tax computation and tax reporting are proper, among other things.

Documents or other information must be provided in language and form acceptable to the Commissioner. This may be an important provision for the auditor to apply, for example, where a transfer pricing agreement, foreign treaty or other financial document is provided to the auditor in a foreign language or transmitted in an unreadable file format.

### **10.6 Corporate Combined Reporting - Taxable Income (830 CMR 63.32B.2(6))**

The components of the income of a taxable member of a combined group (e.g., situations where the member may have income separate and apart from that of the combined group) and the rules for determining a combined group's taxable net income are set forth in the combined reporting regulation at [830 CMR 63.32B.2\(6\)](#).

The combined group's taxable income consists of the aggregate (pooled) taxable net income or loss of every taxable member and non-taxable member of the combined group. Each combined group member, taxable and non-taxable, contributes its income and deductions to the combined group's taxable income calculation from which each taxable member will then calculate its respective apportioned share of such income. See [830 CMR 63.32B.2\(2\)](#).

The auditor needs to verify the un-apportioned income or loss of each combined group member (both taxable and nontaxable) and, once each taxable member's income is verified, the auditor must verify the entire combined group's taxable net income. Therefore, the relevant income on which the auditor must initially focus is the income of each of the taxable and non-taxable members of the combined group.

#### **10.6.1 Taxable Income of a Combined Group Taxable Member**

The auditor will generally follow the procedures used for an individual corporation's return (see [9.3.5 – Income Verification Checklist](#)) to verify that each taxable member of the combined group has included its correct income and deductions. Each taxable member of a combined group is ultimately responsible for an income-based excise determined by its taxable income or loss apportioned or allocated to MA. [830 CMR 63.32B.2\(6\)\(b\)\(1\)](#).

This includes each taxable member's:

- a) share of unitary business income apportionable to MA for each combined group of which it is a member (each share must be determined by reference to a combined report and is determined by applying the apportionment percentage to be used by the taxable member pursuant to such report);
- b) share of any income apportionable to MA of a distinct business activity which is not part of a unitary business conducted in and out of MA by such taxable member;
- c) income from a business conducted entirely within MA by such taxable member but not conducted as a part of the unitary business;
- d) income or loss which is allocable to MA; and
- e) share of net operating loss carryover(s) (including any NOL carryover(s) of another taxable member of the combined group that the taxpayer is permitted to share) to be offset against the taxpayer's taxable net income on a post-apportioned basis (see 830 CMR 63.32B.2(8)).

The auditor must consider all of these possible sources when verifying each taxable member's net income.

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#### **10.6.2 Income and Deductions to be Included in Combined Report**

For each taxable member, gross income and deductions are determined by reference to M.G.L. c. 63, which in turn refers to the federal gross income and federal deductions under the Internal Revenue Code with certain specific adjustments under Massachusetts law. To the extent either the Code or the applicable section of M.G.L. c. 63 affect the determination of gross income or deductions for a taxable member, that should be reflected in the contribution of that member to the combined group's taxable income.

Examples:

- ⇒ a non-U.S. corporation's federal gross income is limited to effectively connected income and U.S. source income, and that is what the combined group will take into account - only deductions reasonably related to this income will be taken into account in determining the combined group's taxable income
- ⇒ a Real Estate Investment Trust (REIT) is allowed a dividends paid deduction under the Code, but that deduction is disallowed in the context of the computation of the combined group's taxable income when the dividend is made by a captive REIT because the distribution made by the REIT to its parent is not treated as a dividend but rather is eliminated. See [DD 10-5: Further Guidance Regarding the Application of the Combined Reporting Regulation, 830 CMR 63.32B.2](#)
- ⇒ a special case exists for a non-U.S. corporation included in the group by reason of the provisions explained in [830 CMR 63.32B.2\(5\)\(b\)\(1\)\(c\)](#) (inclusion triggered by provision of services or licensing of intangible property to a group member resulting in more than 20% of the corporation's gross income). Significantly, this provision pertains to inter-affiliate lending transactions. In these cases, only federal gross income from the services (including lending transactions) or licensing is includible, and only deductions reasonably related and not disproportionate to such income (and in no case more than the amount of that income) are considered
- ⇒ a foreign corporation that is included in the group may have non-U.S. income that is not includible in federal gross income under the Code. In addition, transactions between members of the combined group with respect to their unitary business (i.e., intercompany sales, interest payments and/or royalties, etc.) are subject to elimination in a manner similar to the federal consolidated return provisions at U.S. [Treas. Reg. § 1.1502-13](#). See [830 CMR 63.32B.2\(6\)\(c\)\(5\)](#)

There may be additional Massachusetts adjustments to each member's income that apply including, for example, application of any net operating loss carry forwards under 830 CMR 63.32B.2(8). See [830 CMR 63.32B.2\(6\)\(c\)10](#). Depending on the relevant facts and circumstances, other income or additional adjustments may apply and must be verified by the auditor as part of the overall audit review.

**Taxable Income of Combined Group Taxable Member under Massachusetts Affiliated Group Election**

In the case of an affiliated group election, each taxable member of the combined group is subject to an income-based excise. If one or more members of the affiliated group have apportionable income, then the income-based excise of each taxable member of the group is to be determined based upon the member's taxable income or loss apportioned to this state, which is its apportioned share of the combined group's affiliated group income prior to any post-apportionment adjustments (including application of any NOL carry forwards-see 830 CMR

63.32B.2(8)). [830 CMR 63.32B.2\(6\)\(b\)\(2\)](#).

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### **10.6.3 Combined Group Taxable Income – Audit Verification Procedures**

After each taxable and non-taxable combined group member's income is calculated, the auditor must verify the combined group's total taxable net income which is the sum of those separately determined taxable incomes of each member. The combined reporting regulation provides specific rules for determining a combined group's taxable income. These are set forth in subsections [830 CMR 63.32B.2\(6\)\(c\)\(1\)](#) through (c)(10).

#### **Combined Group Taxable Income Verification - Checklist**

While the auditor will generally follow the procedures used for an individual corporation's return to verify each member's income, certain additional considerations should be taken into account for purposes of the verification of the combined group's taxable income. The following checklist should help the auditor address many of the issues which may be encountered:

- 1) All of the eliminations in the federal consolidation schedule may not be applicable in Massachusetts if the federal return includes members who are not in the Massachusetts combined group. Conversely, where the Massachusetts combined group includes a member that is not in the consolidated federal group (e.g., because the ownership standard for a combined group is greater than 50% ownership and the ownership standard for a federal consolidated return is 80% vote or value), intercompany eliminations will not have been made between that entity and the members of the federal consolidated group. These issues may affect the timing of Massachusetts income and the subsequent computation of the Massachusetts apportionment formula.
- 2) Form 355U – a line item on Form 355U requires the taxpayer to report if there is an excluded parent for the combined group. This may be a foreign corporation or an insurance company or another type of corporation that arguably is not subject to combination. Consider whether this entity should be included in the combined group and determine if there are any brother-sister entities (or chains of entities) that may be unitary with the Massachusetts group.
- 3) Schedule U-M - each corporation the taxpayer includes in the combined report is represented in the income calculations on a separate Schedule U-M, which identifies the member and shows its separate income and deductions

Note: Auditors should compare the income and apportionment factors of each member and should consider questioning members with factors that appear large in relation to their

income and expense items. While specific factor contributions by each member are typically not available until after an audit case is opened (because no schedule similar to U-M is part of the return for apportionment purposes), estimates for sales may be made from the income statement information which is reported on Schedule U-M (and also on Schedule F if it is included). After the audit case is opened, the taxpayer should provide the auditor with workpapers listing the factor contributions of each member to the apportionment denominators

- 4) Compare the group's income reported on Schedule U-CI and Schedule U-E to the taxpayer's financial statements:
  - a. Many international businesses report sales by market area (e.g., North America, Europe, Asia) and the sales and book expenses for the market area (including the United States) frequently track the amounts reported on a U.S. Consolidated return. Significant discrepancies between U.S. and North American market area results may warrant further investigation
  - b. A higher interest expense on the tax return than reported on consolidated worldwide financial statements may indicate that some of the interest is being paid to one or more non-U.S. affiliates. Depending on the circumstances, the recipient of the interest may be subject to water's edge inclusion in the group, the expense may be disallowed under one or more restrictions under the Code, or the expense may be subject to the Massachusetts add-back law
  - c. A lower gross margin percentage may indicate the presence of an intercompany royalty in the cost of tangible property being sold by a U.S. member of the combined group to a related corporation that is not in the combined group. An intercompany royalty may be subject to add-back, even if the property to which it relates is purchased from or manufactured by a third party, if such third party in turn pays a related member a royalty for use of the IP related to such property
  - d. In the event a member leaves the Massachusetts combined group, income which was previously deferred under the intercompany transaction rule is recognized at the time of departure under 830 CMR 63.32B.2(6)(c)(5)(c). Note that a parallel end to the deferral exists if the property is converted to a use outside the combined group's unitary business under 830 CMR 63.32B.2(6)(c)(5)(b). The sale of a division which may trigger recognition of previously deferred income or other adjustments related to the departure of some members from the federal consolidated group is an example of this. See 830 CMR 63.31N.1(5) and (6) for greater detail on these general concepts

- e. Consider any income or loss excluded from Massachusetts taxation as non-unitary (Schedule U-CI includes a total of the amounts excluded by all members). The nature of the excluded items of income should be verified
  - f. Review the taxpayer's work papers showing intercompany eliminations – the summary totals are entered in the return but the detailed transactions should be available from the taxpayer for review by the auditor to verify their validity
- 5) Review Book-to-Tax work papers (including account groupings) and Form 1120 Schedule M or Schedule M-3. This process may require a greater degree of prioritization for a large group but, in essence, the auditor may need to approach this analysis as if the separate corporations were divisions of a large enterprise rather than separate corporate entities
  - 6) in extreme cases, a tax shelter may generate a loss that shelters other income from current taxation - these may be identifiable on federal Schedule M or Schedule M-3
  - 7) Review the federal income tax return(s) for additional potential issues. Again task prioritization is likely to be an issue for the auditor. Review of federal consolidation schedules should pay particular attention to capital gains and losses in order, for example, to identify the basis for claimed NOL carryovers that may not have been otherwise apparent. In large multi-national companies, stock purchases or buybacks may be used to move accumulated profits across national borders without paying tax in either country, and these are disclosed on the U.S. tax return
  - 8) Identify any members included in the prior year's combined report that are not included in the current year's combined report. A liquidating corporation may be required to recognize deferred income when its legal existence terminates. Income from transactions between members ceases to be deferred if either member is no longer a member of the combined group. If the departing member was not part of the federal consolidated return in the prior year (e.g., common ownership was through a foreign corporation), this would not have been picked up on either year's federal tax return.
  - 9) Verify that the taxpayer has reversed any netting and separated out the group's capital and section 1231 gains and loss amounts. These are apportioned as separately stated items under combined reporting. Netting is done at the level of the individual member, rather than at the group level, after considering any other capital and section 1231 gains and loss transactions a taxable member may have for the current year. See [Directive 10-5: Further Guidance Regarding the Application of the Combined Reporting Regulation](#).
  - 10) Because of differences between state and federal rules on capital loss carryovers, auditors are reminded to pay special attention to book to tax discrepancies with respect to capital gains and losses

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### **Combined Group Income from Unitary Business - Water's Edge Calculation**

Where neither an affiliated group election nor a worldwide election has been made ("Water's Edge calculation"), combined group income is computed as follows:

- ✓ income or loss of a member that is not related to the unitary business of the combined group is excluded before the individual incomes of all members are combined
- ✓ if a member is a partner of a partnership (including an LLC that elects to be treated as a partnership for federal tax purposes), the partnership income and factors flow up to that member, but only that portion of the partnership's income or loss that relates to the unitary business of the combined group is included
- ✓ deductions that are related to income excluded from the combined report are likewise excluded. This includes deductions taken by one member that are directly or indirectly attributable to allocable income of another member (see [830 CMR 63.32B.2\(6\)\(c\)7.](#))
- ✓ in all cases, deductions attributed to non-unitary activity must reasonably reflect the costs that are associated with that non-unitary activity. If there are transactions between members involving the unrelated activity (e.g., Member A provides services to Member B's non-unitary business), those transactions are not subject to elimination or deferral of income and should be compensated at arm's length
- ✓ Unitary business income that must be reported by a non-U.S. corporation under a Water's Edge calculation includes:
  - ⇒ Effectively Connected Income (ECI):
    - business income that is "effectively connected" with a U.S. "trade or business" as defined under the Internal Revenue Code
      - Note that a U.S. trade or business may be conducted directly (e.g., through employees) or indirectly (e.g., through an agent or partnership)
    - that is taxable on a net income basis under IRC section 882
    - that should be reported by such non-U.S. corporation on federal Form 1120F
  - ⇒ Fixed, Determinable, Annual, or Periodical (FDAP) income (income which is not ECI) that is U.S. source income:
    - that is taxable on a gross income basis under IRC section 881
    - FDAP income withholding is reported on federal Form 1042-S (i.e., where the recipient corporation does not otherwise file federal Form 1120-F)

- Examples of FDAP income include royalty and interest income
- FDAP income is currently taxed federally at a 30% and that tax applies to the gross amount of U.S. source FDAP income because deductions and netting are not allowed against FDAP income
  - Note: Massachusetts allows deductions against this income
- where a treaty is in place with U.S. - there may be a reduction in the FDAP federal tax rate (in some cases it may be reduced to 0%)
  - Note: Massachusetts has special rules that apply. See TIR 10-16.

**Combined Group Income Calculation under an Affiliated Group Election**

When there is an affiliated group election, the combined group’s taxable income is the aggregate income or loss of every member of the affiliated group, which is generally all of the entities under common ownership whether or not all of those entities are engaged in a unitary business. See [830 CMR 63.32B.2\(10\)](#).

When there is an affiliated group election combined group income is computed as follows:

- ✓ The separately determined incomes of the affiliated group members are added together. This includes the members’ direct and indirect shares of a partnership’s income (this includes a flow-through LLC)
- ✓ Unlike a water’s edge calculation, no subtractions of income or additions of expense or loss are needed (or permitted) from the total income of the combined group (see [830 CMR 63.32B.2\(6\)\(c\)\(1\)](#))
- ✓ Income from intercompany transactions between affiliated group members is deferred in a manner similar to that provided in [U.S. Treasury Reg. § 1.1502-13](#). Previously excluded income is restored if (a) the object of the transaction is resold outside the group; (b) the object is converted to a use outside the unitary business; or (c) when the buyer and seller are no longer members of the same combined group. See 830 CMR 63.31N.1
- ✓ Charitable contributions made in the current year are allowable to the extent they would be allowable based on the combined group’s income under the Code (before Federal to Massachusetts adjustments to income or deductions are taken into account). Carry forward deductions are available for up to 5 years to the extent the contribution was disallowed as a deduction on a previous Massachusetts return. See 830 CMR 63.32B.2(6)(c)(6)
- ✓ Capital gains or losses and Code section 1231 gains or losses are segregated, any netting done federally is reversed, and any federal carryovers are eliminated. These amounts will be allocated or apportioned as separately stated items to the taxable members which will then go through the netting process (in an affiliated group election, separate

apportionment will only have an effect if a member has an un-recaptured section 1231 loss). See [Directive 10-5](#)

- ✓ Except as otherwise specified in [830 CMR 63.32B.2\(6\)\(c\)](#), the Commissioner will apply the principles set forth in [U.S. Treas. Reg. § 1.1502-13](#) as to intercompany transactions, including as to deferrals and eliminations to the extent consistent with state combined group membership and reporting principles in general. See also 830 CMR 63.31N.1(5) and (6)
- ✓ Apart from specific rules otherwise set forth in [830 CMR 63.32B.2\(6\)\(c\)](#), any expense incurred by a member of a combined group that is limited under federal law shall generally be likewise limited under Massachusetts law. See 830 CMR 63.32B.2(6)(c)(10)

### **Combined Group Income Calculation under a Worldwide Group Election**

In any case where the combined group has made and is subject to a valid worldwide election:

- ✓ for any member incorporated in the U.S. or treated as a U.S. corporation under the Code, the income to be included in the combined group's taxable income shall be the taxable net income for such corporation as determined under M.G.L. c. 63 subject to any further adjustments required by 830 CMR 63.32B.2. See [830 CMR 63.32B.2\(6\)\(c\)\(2\)\(b\)\(i\)\(A\)](#)
- ✓ for any member not incorporated in the U.S. and not treated as a U.S. corporation under the Code, the income to be included in the total income of the combined group shall be determined from:
  - ⇒ a profit and loss statement prepared for each foreign branch or corporation in the currency in which its books of account are regularly maintained, adjusted to conform it to the accounting principles generally accepted in the United States for the preparation of such statements and further modified to take into account any book-tax adjustments necessary to reflect federal or Massachusetts tax law. The income in such cases shall include (except as otherwise provided in 830 CMR 63.32B.2) all income wherever derived and is not limited to items of U.S. source income or effectively connected income within the meaning of the Code
  - ⇒ This profit and loss statement of each member of the combined group, and the related apportionment factors, whether United States or foreign, shall be translated into or from the currency in which the parent company maintains its books and records on any reasonable basis consistently applied on a year-to-year and entity-by-entity basis (unrealized foreign currency gains and losses shall not be taken into account, and income apportioned to this state shall be expressed in United States dollars)

See [830 CMR 63.32B.2\(6\)\(c\)2.b.\(i\)](#)

- ✓ any member not incorporated in the United States and not treated as a U.S. corporation under the Code may determine its income on the basis of any other reasonable method consistently applied on a year-to-year and entity-by-entity basis. This is in lieu of the above procedures and subject to the determination of the Commissioner that the income to be reported reasonably approximates income as determined under M.G.L. c. 63. See [830 CMR 63.32B.2\(6\)\(c\)2.b.\(ii\)](#)
- ✓ the income of a non-U.S. corporation includes all income, wherever derived, from the combined group's unitary business. The income of a non-U.S. corporation is not limited to items of U.S. source income or effectively connected income (ECI) within the meaning of the Code
- ✓ Deductions for expenses shown on the foreign corporation's profit and loss statement and related to the unitary business income of the corporation are modified as necessary to reflect federal or Massachusetts tax law
- ✓ Auditors should be alert to the possibility that a non-U.S. member may have sales in Massachusetts that are not from what was U.S. source income under the Code (including sales of inventory property shipped to Massachusetts where title passed outside the U.S.).

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#### **10.6.4 Combined Group Non-Unitary Business Income or Loss**

In order for the auditor to verify the total taxable net income to be included in the combined report, the gross income and deductions of all taxable and non-taxable members derived from the unitary business are combined, as are the denominators of all of the apportionment factors of all of the taxable and non-taxable members. Income, deductions and factors that a member may have that are unrelated to the unitary business (e.g., income from the sale of a non-unitary investment) are excluded from this computation.

Thus, auditors must be aware of scenarios where an item of income or loss reported by a member is not derived from the unitary business ("non-unitary business income").

In the case of a taxable member this includes:

- (1) the member's income from a business conducted by it entirely in MA but not conducted as a part of a unitary business;
- (2) the member's share of any MA apportionable income from a distinct business activity which is not part of a unitary business; and
- (3) the member's income or loss which is allocable to MA.

See [830 CMR 63.32B.2\(6\)\(b\)\(1\)](#).

### **Non-Unitary Business Income – Impact of Affiliated Group Election**

Where there is a valid affiliated group election in effect, the MA combined group is determined solely based upon whether the affiliated group members are under common ownership without consideration of whether such members are engaged in a unitary business. As a result of the election, all income of the affiliated group is apportionable (i.e., there is no non-unitary business income), thereby obviating the need for a non-unitary business income analysis or verification by the auditor.

### **Non-Unitary Business Income - Checklist**

Unitary business income is typically apportioned by a state, whereas non-unitary business income is typically assigned and allocated to a single state. There are a number of consequences arising from situations where corporate income is not income derived from a unitary business:

- ✓ if non-unitary business income is assigned to a single state, that state can tax 100% of such income (i.e., such income may be allocated instead of apportioned to the assigned state)
- ✓ where non-unitary business income of a corporation is passive investment income it will typically be assigned and allocated to such corporation's state of commercial domicile
- ✓ conversely, a state cannot tax a non-domiciliary corporation otherwise doing business in the state on such passive investment income on an allocated or an apportioned basis (i.e., it is excluded from other states)
- ✓ whether an item of income is allocated or apportioned can have a major tax impact. For example, in *General Mills, Inc. v. Commissioner*, 440 Mass. 154 (2003), a parent corporation doing business in MA sold a subsidiary for a significant capital gain which was held to be non-unitary business income in the form of an investment in a subsidiary. As a result, MA could not tax the capital gain because MA was not the parent's commercial domicile
- ✓ losses incurred from discrete business activities of members may be excluded where they are not unitary with the other business of the corporation or with the common business of the combined group

### **Non-Unitary Business Income – Special Rule for Operational Income**

Non-unitary business income of a corporation (i.e., income not derived from a unitary affiliate) may be taxed by a state on an apportioned basis if such income is derived from an asset of such corporation which is held for operational purposes (e.g., working capital). *See, e.g., Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768 (1992); *MeadWestvaco v. Illinois DOR*, 553 U.S. 16 (2008). This income is distinguishable from passive investment non-unitary business income which is held for non-operational purposes (e.g., certain income derived from investment in a subsidiary). Application of the law in a given case depends upon the specific facts and circumstances, such that other similar cases could have different results. Therefore, auditors must be aware of and look out for both types of income and address them according to their respective nature.

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### **10.6.5 Combined Group Taxable Income – Partnerships**

If the unitary business of the combined group includes income derived by a partnership (including a flow-through LLC) that is owned by a taxable or non-taxable member of such group, the group must include both the direct and indirect distributive shares of the partnership's unitary business income in its taxable income. [830 CMR 63.32B.2\(6\)\(c\)\(3\)](#). In determining what partnership income is unitary, the rules predating combined reporting that are set forth in the general apportionment regulation are applicable. See [830 CMR 63.38.1 \(12\)](#).

#### **Impact of Affiliated Group Election**

Where an affiliated group election has been made:

- (1) it is irrelevant whether the pass-through or distributive share income of the combined group members is unitary business income. See 830 CMR 63.32B.2(2)
- (2) the income of the combined group includes all pass-through or distributive share income derived from a partnership (including a flow-through LLC). The income to be included in the total income of the combined group shall be the combined group member's direct and indirect share of such income.

### **10.6.6 Combined Group Taxable Income – Intercompany Dividends**

Transactions in which dividends are paid by one combined group member to another combined group member are generally eliminated from the income of the recipient to the extent such dividends are paid out of the earnings and profits of the unitary business (whether from the current year or an earlier year). However, eliminations are limited to dividends paid out of profits earned while unitary ties existed between the dividend payer and recipient. See generally [830 CMR 63.32.2\(6\)\(c\)4.a. through 4.e.](#)

#### **Intercompany Dividends - Checklist**

With this in mind, auditors must verify that dividends between members of a combined group (i.e., intercompany dividends) have been treated in the following manner:

- ✓ dividends between group members relating to earnings and profits in the combined report are eliminated; any dividends not eliminated may be eligible for the 95% dividends received deduction (MA DRD)
  - ⇒ to determine MA DRD eligibility, the federal dividends received deduction gets added back to income and a deduction for 95% of dividends received from a corporation is allowed (provided the dividend recipient owns at least 15 percent of the voting stock of the dividend payer)(the auditor should verify this ownership amount)
- ✓ a "Last In First Out" (LIFO) rule is applied as between taxable years (and applied *pro rata* with respect to a single taxable year) to determine the amount of the dividend that should be eliminated and what amount may be eligible for the MA DRD:

- ⇒ where dividends paid between group members relate to earnings and profits from the unitary business and are also not from the unitary business (e.g., from non-unitary business activities)
  - ⇒ where dividends paid between group members relate to pre-2009 earnings and profits (i.e., prior to mandatory combined reporting)
  - ⇒ the DRD rules similarly apply where an affiliated group election has been made, except that in such cases there is no reason to differentiate between dividends paid from the unitary business as opposed to otherwise
  - ⇒ prior to 2014, where the dividend payer is an 80%-owned utility corporation and pays a dividend to another utility corporation the DRD is 100% (see M.G.L. c. 63, § 52A(b)). For these years, there is no DRD that applies where the dividend is paid to a utility corporation by a utility corporation that is not 80%-owned
  - ⇒ these rules apply except where the corporation paying the dividend has tax-free earnings and profits from prior activities as a MA corporate trust in which event neither the MA DRD nor the intercompany dividend elimination applies (see [830 CMR 63.32.2\(6\)\(c\)4.d.](#))
- ✓ to the extent an intercompany dividend is made by a REIT, and the dividend is eliminated in the computation of the combined group's taxable income, the REIT must reduce its dividends paid deduction by the same amount as the dividend elimination amount. See [DD 10-5: Further Guidance Regarding the Application of the Combined Reporting Regulation, 830 CMR 63.32B.2](#)
  - ✓ there are a number of examples illustrating the above intercompany dividend rules in the combined reporting regulation (see [830 CMR 63.32.2\(6\)\(c\)4.e.](#))

Note: Auditors should carefully consider whether the effort expended in navigating a potentially complicated earnings and profits history analysis in order to obtain a 5% increase in taxable income subject to combined group apportionment (i.e., a 95% versus 100% deduction where there are non-unitary earnings) is justified.

### **10.6.7 Combined Group Taxable Income – Intercompany Transactions**

Under the unitary business principle intercompany transactions occurring between members of a unitary business are generally eliminated. With certain exceptions, this rule is followed under the combined reporting regulation.

#### **Deferral of Income from Intercompany Transactions**

Income derived from intercompany transactions is treated as deferred under the combined reporting regulation in a manner similar to that provided by the federal consolidation rules. [830 CMR 63.32.2\(6\)\(c\)5.](#) Auditors must be aware of and look for income arising from intercompany

transactions between combined group members and evaluate how the taxpayer has treated such income, keeping in mind the time and work involved in the process by prioritizing and focusing review on major transactional events and the income arising therefrom.

Income arising from an intercompany transaction between members of the same combined group relating to the group's unitary business (or income from intercompany transactions where there is an affiliated group election) will be deferred in a manner similar to that provided by the federal consolidation rules in [U.S. Treas. Reg. § 1.1502-13](#). Under the combined reporting regulation, income from intercompany transactions is deferred until one of the following specific "recognition events" triggers deferred income which must then be recognized by the seller and apportioned as unitary business income:

- a. when a buyer disposes of an asset acquired from a seller in a deferred transaction by means of a sale to an entity that is not a member of the combined group;
- b. when a buyer uses an asset acquired from a seller in a deferred transaction outside of the unitary business, or resells it to another combined group member for use outside of the unitary business; or
- c. when a buyer and seller are no longer members of the same combined or affiliated group

[830 CMR 63.32.2\(6\)\(c\)5](#). subsections (a.) through (c.).

When any of the above events occur, the deferred income is recognized as income of the seller and as such must be apportioned as unitary business income provided there is no affiliated group election in which case the income will be recognized as affiliated group income at the time of the intercompany transaction. Auditors should refer to the detailed rules set forth in the basis regulation (830 CMR 63.31N.1 (5) & (6)).

### **10.6.8 Combined Group Taxable Income – Other Provisions**

Auditors must be mindful of other provisions in the combined reporting regulation which may effect the verification of combined group taxable income.

#### Treatment of Charitable Expense Deductions – Checklist

Auditors should recognize that the IRC section 170 charitable contribution 10% limitation and carry forward concepts apply within the context of a combined group and are addressed in the combined reporting regulation. [830 CMR 63.32B.2\(6\)\(c\)6](#). A charitable expense incurred by a member of a combined group which is allowable as a deduction pursuant to IRC section 170:

- ✓ must be deducted first from the unitary business income of the combined group with any section 170 income limitation applied to such group income (or from the affiliated group income with such income limitation applied where there is an affiliated group election)

- ✓ if the total contributions of all combined group members exceed the amount which may be deducted from the group's income, those contributions shall be allowed *pro rata* based upon each member's respective contribution
- ✓ any group member that (1) has a charitable expense which may not be deducted from the group's income under [830 CMR 63.32B.2\(6\)\(c\)6.](#) and (2) has net income from other sources (where an affiliated group election has not been made), must deduct that expense from such other source income (and also apply any section 170 income limitation to such other source income ) before any income allocation or apportionment
- ✓ a member with a disallowed charitable deduction under 830 CMR 63.32B.2(6)(c)6. must carry it forward to a subsequent year. The carried forward deduction will be treated as if it was originally incurred by such member in the subsequent year. The same charitable deduction rules will apply to determine the allowable deduction, and the carry forward shall be limited to the period provided under the Code
- ✓ if a member incurring a charitable expense subsequently leaves the combined group and enters a new combined group the same rules will apply to the use of the charitable expense in the new group

#### Assignment of Allocable Expenses

Auditors encountering a group member with allocable income must assign the corresponding allocable expense of any other group member which is directly or indirectly attributable to the group member's allocable income:

[a]ny expense of one member of the unitary group which is directly or indirectly attributable to allocable income of another member of the unitary group shall be allocated to that other member as a corresponding allocable expense, as appropriate.

[830 CMR 63.32B.2\(6\)\(c\)7.](#) This rule does not apply when there is an affiliated group election.

#### Capital and IRC Section 1231 Gains and Losses from Property Sale or Exchange - Checklist

Auditors must apprise themselves of the rules in the combined reporting regulation which allow for offset of capital and IRC section 1231 gains and losses within a combined group. These rules are generally consistent with existing related federal and MA principles. [830 CMR 63.32B.2\(6\)\(c\)8.](#) The following checklist addresses these rules:

- ✓ capital and section 1231 gains or losses from the sale or exchange of property must be removed from the combined group's taxable income and be apportioned and allocated under [830 CMR 63.32B.2\(6\)\(c\)8.](#)a. through e.
  - ⇒ a. Before any netting of capital gains and losses and Code section 1231 gains and losses, the gains and losses are segregated by type (i.e. capital or Code section 1231) and then classified as apportionable or allocable, as the case may be

- ⇒ b. Each taxable member's apportionable capital gains and losses and Code section 1231 gains and losses derived from the sale or exchange of property used in the combined group's unitary business (or the activities of the combined group in the case of an affiliated group election) are then aggregated and apportioned to the member using the apportionment factor applicable to such member as determined under 830 CMR 63.32B.2(7), to arrive at the member's Massachusetts gains and losses for the respective classes of income or loss
- ⇒ c. The apportioned capital and Code section 1231 gains and losses referenced in [830 CMR 63.32B.2\(6\)\(c\)8.b.](#) and, in the case where no affiliated group election has been made, any capital or Code section 1231 gains and losses that (i) are to be allocated to Massachusetts, (ii) are to be apportioned to Massachusetts based upon the apportionment factors of the taxpayer member only (i.e., because the gains or losses derive from the separate non-unitary business activity of the member), or (iii) are derived from the sale or exchange of property used in the unitary business of another combined group and have been separately apportioned under these rules as applied to that group, are then netted by each taxable member using the rules of Code sections 1231 and 1222, without regard to any of the member's gains or losses that are to be allocated to another state
- ⇒ d. Any resulting Massachusetts net capital gain or ordinary income (and any ordinary loss, in a case where the netting of Code section 1231 gains and losses produces a resulting ordinary loss) of a taxable member produced by the application of the preceding subsections shall then be added to (or, in the case of a resulting ordinary loss after netting of Code section 1231 gains and losses, subtracted from) the taxable income of that member. See 830 CMR 63.32B.2(6)(b)1. Any resulting Massachusetts capital loss shall not be offset against the member's taxable income and shall not be carried forward to subsequent years
- ⇒ e. In the instance where there is a fiscalized member of the combined group, the gains and losses to be aggregated and apportioned under [830 CMR 63.32B.2\(6\)8.b.](#) must first be assigned to the combined group's taxable year. See 830 CMR 63.32B.2(12)(b) and (c). After the aggregation and apportionment under [830 CMR 63.32B.2\(6\)\(c\)8.b.](#), the resulting Massachusetts gains and losses are then adjusted to align such gains and losses to the tax year of the taxable member to which it relates

- ✓ the remaining combined group's taxable income must be apportioned to the combined group taxable members without regard to such capital and section 1231 gains or losses
- ✓ the removal of such gains and losses from the combined group's taxable income shall not have an effect on the apportionment factors of the group or any of its members
  - ⇒ For example, where a member has a capital gain resulting from the sale of property used in the combined group's unitary business, that gain shall be reflected in the apportionment computation of the group and such member (except as otherwise provided in M.G.L. c. 63, § 38 or the regulations thereunder or in 830 CMR 63.32B.2)

Auditors seeking additional guidance should refer to Department Directive [DD 10-5: Further Guidance Regarding the Application of the Combined Reporting Regulation, 830 CMR 63.32B.2](#) which illustrates the application of, among other things, the rules set forth in [830 CMR 63.32B.2\(6\)\(c\)8](#), relating to a combined group member's calculation of capital and IRC section 1231 gains and losses.

#### **10.6.9 Combined Group Taxable Income – Federal Default Provisions**

The rules set forth in the combined reporting regulation under 830 CMR 63.32B.2(6)(c) generally apply to determine the combined group's taxable income to be apportioned to the taxable members of the combined group (or to be attributed where there is no member with apportionable income).

Auditors may have situations where the facts and circumstances do not fit squarely within the confines of these rules. Where the specific rules of 830 CMR 63.32B.2(6)(c) do not apply, the federal deferral and elimination provisions of U.S. Treas. Reg. § 1.1502-13 should be followed to the extent they are consistent with MA combined group membership and reporting under M.G.L. c. 63 section 32B and with Chapter 63 generally. [830 CMR 63.32B.2\(6\)\(c\)9](#). Further, any expense incurred by a combined group member that would be limited under federal law must likewise be limited under MA law. [830 CMR 63.32B.2\(6\)\(c\)10](#).

#### **10.6.10 Combined Group Taxable Income – Election to Adjust Federal Basis**

Auditors must recognize and evaluate the validity and maintenance of an election to adopt a MA-adjusted basis for all assets of every combined group member that was not previously a MA taxpayer. This election may be made under 830 CMR 63.32B.2(6)(d) of the combined reporting regulation.

When a corporation that was not previously a Massachusetts taxpayer enters into or is first included in a combined group the basis of such member's assets will be the basis of such assets for federal income tax purposes. However, under the combined reporting regulation, the principal reporting corporation of a combined group may make an irrevocable election to determine and apply a Massachusetts-adjusted basis for all assets of every member of the combined group that was not previously a Massachusetts taxpayer. This includes any non-

taxpayer corporation that subsequently enters or otherwise is included in the combined group after the election has been made.

The combined group must make the election during the period of limitations for abatement under M.G.L. c. 62C, § 37 (without taking into account M.G.L. c. 62C, § 30 (relating to federal income tax changes)), for the tax year that first includes a previously non-taxable member. To uphold the election, the principal reporting corporation must keep and maintain adequate records demonstrating the appropriate Massachusetts-adjusted basis for all such assets. If a taxpayer is unable to reasonably document its basis adjustments under the election for any group member, the election will be treated as void as to all group members and to any taxable periods that are within the statute of limitations for assessment.

Where the election has been made, auditors must verify that the taxpayer possesses adequate records substantiating the proper MA basis adjustments and, upon requesting and receiving the same, must verify that the appropriate Massachusetts adjustments for all such assets were made and applied.

#### **10.6.11 Combined Group Taxable Income - Relation to Non-Income Measure**

A member of a combined group that is subject to M.G.L. c. 63, § 39 (whether or not it is taxable on its income under M.G.L. c. 63) is also separately responsible for the minimum excise or a non-income based excise (whichever amount is greater). The non-income measure continues to be computed in the same manner. [830 CMR 63.32B.2\(6\)\(b\)\(3\)](#). As a result, a corporation may be required to compute its separate stand-alone apportionment percentage to carry out the non-income measure calculation. See [10.11 Relation of Non-Income Measure to the Combined Report](#) below.

### **10.7 Corporate Combined Reporting Group Income Apportionment**

If one or more combined group members has income from the group's unitary business activities that is taxable in another state (or, where there is an affiliated group election, if one or more members of the group are taxable on their income from business activity in another state), each combined group taxable member must determine its net income derived from the combined group's activities by applying its respective apportionment percentage as determined and calculated under the combined reporting regulation in [830 CMR 63.32B.2\(7\)](#).

#### **Combined Group Apportionment Calculation**

Corporations participating in a combined report calculate their income taxable in Massachusetts in the same general manner as they would if filing a separate return except that both the taxable net income to be apportioned and the denominators of the various factors are determined on a group basis. The determination of and the adjustments required to calculate the combined group's apportionment factors are addressed in [830 CMR 63.32B.2\(7\)](#) of the combined reporting regulation.

Note: the apportionment provisions under the combined reporting regulation do not apply to determine the non-income measure of a combined group member subject to tax under M.G.L. c. 63, § 39 which is to be separately determined by such member under that section. See [10.11 Relation of Non-Income Measure to the Combined Report](#).

### **10.7.1 Corporate Combined Reporting Group Apportionment - Audit Review Checklist**

The auditor must verify the apportionment factor or factors that apply to each taxable member of a combined group. This entails (1) determining each taxable member's numerator based upon its own separate factors which are sourced to Massachusetts, and (2) determining the denominator of the apportionment factor or factors by including the property, payroll, and sales/receipts, regardless of location, of the combined group as a whole.

The following steps should be taken by the auditor as a starting point in planning the apportionment review. At all times the auditor is expected to bear in mind the audit risk (in dollar terms) of an issue – focus on issues that are likely to result in changes that have significant effect and avoid spending time on insignificant issues. Note that the sections following the checklist provide greater detail with respect to the determination and computation of each combined group member's apportionment factors and percentage calculation:

- ✓ Review and confirm the taxpayer's eligibility for apportionment. Nexus and apportionment eligibility are determined at the level of the individual corporation. Information gathered in the income and balance sheet verification sections of the audit should be considered here and throughout the apportionment review. If the taxpayer, on a separate company basis, has a bona fide office in another state, the Schedule A should clearly confirm this. The nature of the taxpayer's business may also make this clear-cut (e.g., the provision of landscaping services to customers within 25 miles of Fitchburg).
- ✓ Review the taxpayer's financial statements to verify that the taxpayer has used the correct apportionment formula (standard, manufacturing, mutual fund service, etc.). Note that different members of a controlled group may be required to use different formulas. If there is a question of whether or not the taxpayer qualifies to use a particular method, the taxpayer must document the reasons for their choice (e.g., provide figures showing that manufacturing accounts for 25% or more of their receipts).
- ✓ Review the taxpayer's apportionment work papers and verify the calculation of both the numerator and the denominator of each factor based on the figures provided. Determine if the taxpayer has included factors from a partnership or other pass-through entity in the apportionment calculations (and if it should). If the apportionment workpapers provided do not include partnership factors, there is evidence that they should, and the denominators shown on the return exceed those in the workpapers, this should be taken into account in prioritizing issues to be addressed; where the taxpayer

is likely to be able to prove the original figures with additional documentation, audit time may be better allocated to other issues.

- ✓ Review Schedule U-M and Request Member Contribution Workpapers. Each corporation the taxpayer included in the combined report is represented in the income calculations by a Schedule U-M which identifies the member and shows its separate income and deductions. While no similar schedule is part of the return for apportionment purposes, the taxpayer should have work papers listing the contributions of members to the apportionment denominators.

Note: Auditors should typically compare the income and apportionment factors of a member and may question members with factors that appear large in relation to their income and expense items. Factor contributions by member are usually not available until after the audit is opened, but estimates for sales may be made from the income statement information on Schedule U-M.

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### **10.7.2 Combined Group Member Apportionment - Factor Numerators**

The auditor must verify that the numerator of the apportionment factor or factors which apply to each taxable member includes, to the extent applicable, the property, payroll, and sales/receipts of that separate member which are sourced to Massachusetts. The combined group member numerator should be verified by applying the rules provided under M.G.L. chapter 63 (corporate excise generally), chapter 63 section 2A (financial institutions), section 38 (general apportionment), or section 42 (alternative method of determining net income) subject to any adjustments provided for in 830 CMR 63.32B.2(7) of the combined reporting regulation. [830 CMR 63.32B.2\(7\)\(b\)](#). For guidance with respect to determining the combined group member numerator see [9.4 Corporate or Financial Institution Income Apportionment](#). The apportionment adjustment provisions in the combined reporting regulation will be discussed in further detail below.

#### **Determination of Factor Numerators - Checklist**

Each taxable member computes a separate numerator. Any property, payroll or sales that are included in the combined group's denominator and attributable to Massachusetts under the rules governing apportionment for that member are in the member's separate numerator subject to the following adjustments:

- ✓ No amount can be in the numerator that is excluded from the denominator of any factor.
- ✓ In the case of tangible property leased by one member and used by another, any property in Massachusetts is includible in the numerator of the corporation that uses the property.

- ✓ In the case of tangible property leased by one member to another member, any property in Massachusetts is includible in the numerator of each to the extent it is included in the denominator (8 x annual rent for the lessee, cost less that amount - but never less than zero - for the lessor.)
- ✓ In the case of intercompany leases of employees, the wages in Massachusetts are includible in the numerator of the member for whom the employee is providing actually services. If the employee is providing services for more than one member of the group a reasonable allocation may be made.
- ✓ Sales of tangible property shipped or delivered to purchasers in other states are considered sales in Massachusetts under the “throwback” rule only if no member of the combined group is taxable in the state of destination on its income from the unitary business. See [10.7.5 Combined Group Income Apportionment - Special Rules](#) below
- ✓ When determining the sales factor numerator of each taxable member of the combined group, the MA sales of all non-taxable members must be shared *pro rata* among the taxable members. These “Finnigan adjustments” are more fully discussed in subsection [10.7.5 Combined Group Income Apportionment - Special Rules](#) below
- ✓ For sales other than tangible property, any sales in Massachusetts are includible in the numerator of the corporation making the sale, but in sourcing the sale all of the activities of all of the members are considered. This is primarily applicable in sourcing sales prior to the change to Market Sourcing for years beginning on or after January 1, 2014

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### **10.7.3 Combined Group Member Apportionment - Factor Denominators**

The next step for the auditor is to verify the denominators of the apportionment factor or factors which apply to each taxable member of a combined group. The combined group member denominator must include the property, payroll, and sales/receipts, regardless of location, of the combined group as a whole. The combined group member denominators are determined by adding together the individual denominators of all of the members of the combined group. The individual denominators of each member are determined in the same manner as the individual numerator of each member, by applying the rules under M.G.L. chapter 63 (corporate excise generally), chapter 63 section 2A (financial institutions), section 38 (general apportionment) or section 42 (alternative method of determining net income) subject to any adjustments provided for in 830 CMR 63.32B.2(7) of the combined reporting regulation. [830 CMR 63.32B.2\(7\)\(d\)](#). For guidance with respect to determining each individual combined group member denominator see [9.4 Corporate or Financial Institution Income Apportionment](#). The apportionment adjustment provisions in the combined reporting regulation will be discussed in further detail below. The denominators of each member of the combined group shall be individually determined under said rules that apply to such member (or under such rules that would apply to such

member in the case of a non-taxable member assuming that such non-taxable member was subject to Massachusetts income tax). The denominators of the property and payroll factors of the combined group as a whole shall include the property and payroll factor denominators, determined under M.G.L. c. 63, § 38, of a combined group member that either is to apply the single sales factor apportionment rules set forth under M.G.L. c. 63, § 38 or that would be required to apply these rules if such member were subject to Massachusetts income tax. Each taxable member contributes its property, payroll and sales to the apportionment factor denominators which it uses to determine how much common (apportioned) income it must share. The denominators of the applicable apportionment factors are shared by all members of the group. With the exception of a “mixed” group (defined as a group that includes at least one financial institution and one corporation that is not a financial institution), each member (including non-taxable members and corporations that are not separately taxable in more than one state) computes its denominator for each factor normally (under M.G.L. c. 63 §2A or §38 as appropriate). A corporation computes denominators for all three factors regardless of whether or not that factor would apply in that member’s separate company apportionment calculation (e.g., a corporation eligible to use 100% sales factor apportionment still computes denominators for the property and payroll factors as part of this process. Factors derived from a corporation’s interest in a partnership are included to the extent the partnership’s income is included in the combined group’s unitary business. The separate denominators of all the members are now combined as follows:

1. Property, payroll and sales attributable to any item excluded from Federal Gross Income are excluded from apportionment calculations.
2. Property, payroll and sales that are unrelated to the income of the combined group’s unitary business are also excluded (including factors related to allocable or separately apportioned income of any member).
3. Intercompany transactions related to the combined group’s unitary business are generally disregarded;
  - ⇒ Intercompany leases of tangible property are included in the property factor of the lessee at 8 times the annual rent and included in the property factor of the lessor at original cost less any amount included by the lessee (but not below zero). All intercompany leases/rentals must be at fair value in computing the apportionment.
  - ⇒ Intercompany sales, including intercompany rents, are disregarded (eliminated) in calculating the sales factor. To the extent the property is sold outside the group it will be included in the factor of the corporation making the “external” sale when that sale is made.
  - ⇒ Intercompany sales of tangible property do not affect the cost of that property for apportionment (e.g., inventory manufactured by one member

of the group does not increase in value because it is sold to another member).

4. The remaining amounts for each member are totaled.

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#### **10.7.4 Taxable Member Apportionment Percentage Computation**

Each taxable member will use its separate numerator and the group's combined denominator to compute each apportionment factor. Each taxable member will then compute an apportionment percentage using the respective apportionment formula applicable to that corporation based on its activities (e.g., a manufacturing corporation will use 100% of the sales factor to determine its apportionment percentage, a financial institution will use three factor apportionment, etc.). [830 CMR 63.32B.2\(7\)\(a\)2.](#)

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#### **10.7.5 Combined Group Income Apportionment - Special Rules**

There are a number of special rules in the combined reporting regulation of which auditors must be aware when computing combined group apportionment. Auditors must verify whether these rules have been applied by the taxpayer and, if not, auditors must make the necessary adjustments reflecting these special circumstances as part of the audit review.

##### **Apportionment Sales Factor - Finnigan Adjustments (830 CMR 63.32B.2(7)(b))**

Sales sourced to Massachusetts but made by a non-taxable member are totaled and are attributed to the members that are taxable in the commonwealth. These "*Finnigan*" sales are allocated among the taxable members in the same ratio that those members own sales in Massachusetts bear to the total sales in Massachusetts of the taxable members (e.g., Member A has \$10,000 in Massachusetts sales, Member B has \$6,000 and Member C has \$4000. Member A will be allocated 50% of any *Finnigan* sales.)

##### **Finnigan Adjustments - Checklist**

Where a combined group includes one or more taxable members and one or more non-taxable members, the sales/receipts factor numerator(s) of the taxable member or members are increased in the following manner:

- ✓ The total amount of sales or receipts sourced to Massachusetts under M.G.L. c. 63, § 2A, 38 or 42, as applicable, is determined for all non-taxable members
- ✓ Each taxable member determines a fraction, the numerator of which is the sales/receipts factor numerator of such member, determined without any adjustments under 830 CMR 63.32B.2(7)(b), and the denominator of which is the sum of the sales/receipts factor numerators of all taxable members, as determined without any adjustments under 830 CMR 63.32B.2(7)(b); and

- ✓ For each taxable member, the total Massachusetts receipts of the non-taxable members is multiplied by the fraction described in 830 CMR 63.32B.2(7)(b)2., and the resulting product is added to the sales factor numerator, as otherwise determined, of the taxable member.

[830 CMR 63.32B.2\(7\)\(b\).](#)

**Sales Factor - Application of M.G.L. c. 63 § 38(f) Throwbacks (830 CMR 63.32B.2(7)(c))**

Auditors will still apply the “throwback” rule for purposes of determining whether sales are to be sourced to Massachusetts and included in the numerator of the sales factor of a taxable member of a combined group under M.G.L. c. 63, section 38(f). Under combined reporting, a taxable member is considered taxable in any state in which any member of its combined group is subject to tax with respect to the income derived from the group’s unitary business. In the case of an affiliated group election, the “throwback” rule applies in any state in which any member of the combined group is taxable.

**Note:** The “throwback rule” applies only if at least one member of the combined group is entitled to apportion its income under M.G.L. chapter 63.

[830 CMR 63.32B.2\(7\)\(c\).](#)

**Inclusion of Partnership Factors (830 CMR 63.32B.2(7)(e))**

Where a taxable member of a combined group receives unitary business income through direct or indirect ownership interest in a partnership (or disregarded entity), the property, payroll, and sales factors of such taxable member shall include its *pro rata* share of the factors relating to such unitary business income as attributed to the taxable member through such ownership interest. See 830 CMR 63.38.1(12) (*Corporate Partners*).

Where there is a valid affiliated group election, a taxable member of a combined group must include in its property, payroll and sales factors its *pro rata* share of the property, payroll and sales factors relating to all income that is attributed to the taxable member through its direct or indirect ownership interest in a partnership (or disregarded entity).

830 CMR 63.32B.2(7)(e).

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**Exclusion of Factors Related to Items Excluded from Federal Gross Income (830 CMR 63.32B.2(7)(f))**

Auditors must carefully review items excluded from federal gross income to ensure that corresponding items are also excluded from the numerator and denominator factors of each combined group member:

- ✓ Where items of gross income are excluded from the federal gross income of a combined group member, the gross receipts to which such items of gross income are directly attributable should be excluded from the numerator and denominator of such member’s sales factor

- ✓ Any property or payroll (or portion thereof) relating to such gross receipts should also be excluded from the property or payroll factors of such combined group member

Example (when a combined group is not under a valid worldwide election)-for any member not incorporated in the US and not treated as a US corporation under the Internal Revenue Code, the income to be included in the combined group total income must be taxable net income as determined under Chapter 63 (See 830 CMR 63.32B.2(6)(c)2.a(i)(b).). Where receipts to which any items of gross income are directly attributable are not included in the taxable net income determination, those receipts should also be excluded from the numerator and denominator of such member's sales factor. Likewise, any property or payroll (or appropriate portion thereof) that relate to such receipts should also be excluded from the property or payroll factors of the combined group member

- ✓ in any case where a corporation is included in a combined group solely because of the applicability of 830 CMR 63.32B.2(5)(b)1.c. (i.e., default Water's Edge where member earns > 20% of its income directly or indirectly from intangible property or service-related activities, etc.), the income and factors of such corporation to be included in determining the combined group's taxable income should be determined pursuant to 830 CMR 63.32B.2(5)(b)1.c. and 830 CMR 63.32B.2(5)(b)3. and 4. (application of Water's Edge rules)

#### [830 CMR 63.32B.2\(7\)\(f\).](#)

#### **Intercompany Transactions (830 CMR 63.32B.2(7)(g))**

Auditors must verify that the special apportionment rules involving intercompany transactions under the combined reporting regulation have been addressed in determining and computing each member's apportionment factor(s):

- ✓ in determining the numerator and denominator factors of combined group members, transactions between combined group members that relate to the unitary business are generally disregarded
- ✓ intercompany transactions between a combined group member and a partnership whose income is included in the combined group unitary business are also generally disregarded where such transactions relate to the unitary business to the extent the group member's distributive share interest in partnership income is consistent with the rules set forth in 830 CMR 63.38.1(12)
- ✓ where a taxable member of a combined group has made an affiliated group election, all transactions between the members of the Massachusetts affiliated group are generally disregarded

- ✓ a member that sells property manufactured by another group member must take into account the joint activities of both corporations to determine its apportionment formula. If, when taken together, the activities of both corporations would be considered substantial manufacturing the member making the sale will use 100% of the sales factor to calculate its apportionment percentage. See 830 CMR 62.32B.2(7)(g)2 and examples

[830 CMR 63.32B.2\(7\)\(g\).](#)

**“Mixed” Group Apportionment Computation (830 CMR 63.32B.2(7)(h))**

Auditors encountering “mixed” combined groups (i.e., a combined group with at least one member that qualifies as a financial institution and one member that is not a financial institution) must verify that the apportionment computation included financial institution property and receipts factors with certain adjustments:

- ✓ Only members that qualify as financial institutions (whether or not taxable in Massachusetts) include financial institution intangible property (loans, etc.) in their property factors. Intercompany loans are disregarded. The value of the financial institution intangible property is reduced by 80% in calculating both the numerator and the denominator of the property factor
- ✓ All members must include financial institution receipts as directed in M.G.L. c. 63 sections 2A(d)(i) through (d)(xi) in the computation of their respective sales factors. Only financial institutions should include receipts as specified in section 2A(d)(xii). “Financial institution type” receipts received by non-financial institutions are sourced as provided in section 2A(d)

[830 CMR 63.32B.2\(7\)\(h\).](#)

**Mutual Fund Service Corporations (830 CMR 63.32B.2(7)(i))**

Auditors must be aware of and be able to verify the apportionment percentage rules applying to Mutual Fund Service Corporations (MFSCs) provide for under the combined reporting regulation (830 CMR 63.32B.2(7)(i)):

- ✓ An MFSC will divide its factor numerators into two separate types - (1) those related to its mutual fund sales and (2) those related to its other business activities
- ✓ the MFSC will determine two apportioned shares of the income from the combined group’s common business – (1) one share for its mutual fund sales activities (using its Mutual Fund Sales in Massachusetts and 100% of the sales factor) and (2) one share for its other activities (determined using the 3-factor double-weighted sales formula but not including any Massachusetts property, payroll and sales related to the mutual fund sales income)

- ✓ these 2 apportioned shares will be combined to determine the mutual fund service corporation's total income from the group's unitary business

[830 CMR 63.32B.2\(7\)\(i\).](#)

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**Interaction with Alternative Apportionment Rules (830 CMR 63.32B.2(7)(j))**

Generally the apportionment rules provided by 830 CMR 63.32B.2(7) of the combined reporting regulation are not altered or affected by the alternative apportionment methods provided in M.G.L. c. 63 sections 2A(g), 38(j) or 42 (the "alternative apportionment rules"). Such alternative apportionment rules affect an individual corporation's factors and therefore do not alter the combined group apportionment rules provided by 830 CMR 63.32B.2(7).

However, the auditor must be aware that the alternative apportionment rules may modify the combined group apportionment provisions (1) to the extent specified in the alternative apportionment regulations under M.G.L. c. 63, § 38(j) or (2) to the extent specified in agreements relating to individual taxpayers under M.G.L. c. 63, §§ 2A(g) and 42.

Examples of cases where alternative apportionment modification might be necessary include:

- ✓ the case of alternative apportionment methods adding or deleting particular types of property, payroll, or receipts from the factors described in M.G.L. c. 63, §§ 2A and 38 or
- ✓ the case of alternative apportionment methods invoking unique apportionment factors unrelated to property, payroll, or receipts

In such cases, the alternative apportionment modifications may affect the factors of the group as a whole or the factors of one or more members, to the extent specified in such alternative apportionment regulations or agreements

[830 CMR 63.32B.2\(7\)\(j\).](#)

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**10.7.6 Corporate Combined Reporting Group Allocable Income (830 CMR 63.32B.2(7)(k))**

Where a taxpayer corporation is engaged in a unitary business with one or more corporations, and no member of the combined group has income from the activities of the group's unitary business that is taxable in another state, all of the income from the unitary business is allocable to Massachusetts. [830 CMR 63.32B.2\(1\)\(b\)](#). The rules that govern when the combined group does not include any member of the combined group that is taxable in another state are set forth in the combined reporting regulation at 830 CMR 63.32B.2(7)(k). Where a combined group does not have any member with income from the activities of the group's unitary business that is taxable in another state (or, when there is a valid affiliated

group election any member that is taxable on its income from business activity in another state), all of the combined group's taxable income is taxable in Massachusetts.

#### **Combined Group Allocable Income - Checklist**

Auditors must verify that the rules relating to combined group allocable income have been properly applied in accordance with the combined reporting regulation, keeping in mind that these rules apply when there is no apportionment calculation by virtue of the fact that all of the combined group's income is allocable to Massachusetts:

- ✓ where no member of the combined group is taxable on the group's unitary income in another state, apportionment does not apply and all of the combined group's unitary income is taxable in Massachusetts. Each member must determine its share of the combined group's taxable income by multiplying such income by a fraction which represents the average of the taxable member's respective shares (i.e., its property or payroll ratio):
  1. of owned or rented property of the unitary business; and
  2. of payroll of the unitary business; or
  3. of all property and payroll when there is a valid affiliated group election
- ✓ Each taxable member's respective share must be determined under the provisions of M.G.L. chapter 63 but with intercompany transactions eliminated
- ✓ If a financial institution is a member of the combined group then its property for purposes of this attribution of the combined group's taxable income is calculated under the provisions of M.G.L. c. 63 § 2A, however, the property value determined under M.G.L. c. 63, § 2A for certain intangible property is reduced by 80%. See 830 CMR 63.32B.2(7)(h)1. The 80% reduction is not to be made when the combined group consists solely of a combined group of financial institutions. All other group members are to determine their property and payroll for purposes of this attribution of the combined group's taxable income under M.G.L. c. 63, § 38. The income separately attributed to each combined group member, when totaled, must equal 100% of the combined group's taxable income
- ✓ Special Rule for "Operational" Income - income that does not derive from a unitary affiliate may be taxable by a state on an apportioned basis if the income derives from an asset held for operational purposes (e.g., working capital). See, e.g., *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768 (1992); *MeadWestvaco v. Illinois DOR*, 553 U.S. 16 (2008)

### **10.7.7 Combined Group Apportionment - Examples (830 CMR 63.32B.2(7)(I))**

There are a number of detailed and illustrative combined group apportionment examples in the combined reporting regulation to which auditors should refer when they are in the process of verifying a combined group's apportionment. The examples also provide specific citations from which the auditors may gain additional insight. See [830 CMR 63.32B.2\(7\)\(I\)](#), Examples 1. through 8.

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## **10.8 Corporate Combined Reporting Group - Net Operating Loss Carry Forwards**

For the auditor, verifying generation, application and carry forward of Net Operating Losses (NOLs) represents one of the most challenging aspects of performing a corporate combined reporting audit review. While generation, application and carry forward of NOLs generally follows the rules applicable to stand-alone business corporations, there are important distinctions set forth in the combined reporting regulation to which the auditor must give close attention.

In general, if computation of a combined group's taxable income results in a taxable net loss a taxable member may carry forward its apportioned share of the loss to offset against its post-apportioned taxable income derived from the combined group in a future year to the extent the carry forward and offset is consistent with the requirements and limitations set forth in M.G.L. c. 63, § 30.5 and M.G.L. c. 63 generally. [830 CMR 63.32B.2\(8\)](#). See [9.6 Net Operating Loss Deductions](#). NOL carry forwards that were generated prior to combined reporting, or which are generated outside of a combined report, cannot be shared but the combined group member which generated it can apply it against its share of group income on a post-apportioned basis (subject to potential limitation). See [DD 10-5: Further Guidance Regarding the Application of the Combined Reporting Regulation, 830 CMR 63.32B.2](#); [LR 10-6: Application of 830 CMR 63.32B.2\(8\)\(f\), Limitation on Use of Pre-combination NOL](#).

### **10.8.1 Corporate Combined Reporting Group - NOL Highlights**

The following highlight the important aspects of combined group NOLs with which the auditor should familiarize for purposes of completing a corporate combined reporting audit:

- ✓ a taxpayer must determine its apportioned share of a combined group's taxable income prior to deducting any NOL carry forwards for a taxable year
- ✓ a taxpayer with more than one NOL carry forward derived from losses in more than one tax year must apply such NOL carry forwards in the order in which the loss was incurred (i.e., the oldest carry forward must be deducted first)

- ✓ neither a financial institution (M.G.L. c. 63, § 2) nor a pre-2014 utility corporation (M.G.L. c. 63, § 52A) is allowed an NOL carry forward
- ✓ NOLs may be carried forward but may not be carried back
- ✓ NOLs sustained in any taxable year beginning on or after January 1, 2010 may be carried forward for not more than 20 years (NOLs sustained in taxable years beginning prior to January 1, 2010 are limited to a 5 year carry over except as provided under the operation of some other statute). Taxpayers claiming a benefit for a pre-2010 NOL must support such a claim and auditors should request the same from the taxpayer to verify
- ✓ To apply the 5-year or 20-year NOL limitation, each “taxable year” is counted regardless of the number of days included. For example, a taxpayer required to file returns for taxable years from January 1 - February 15, 2011, February 16 – March 31, 2011 and April 1 – December 31, 2011 will count the periods as three (3) taxable years, not one because the three periods fell within one calendar year
- ✓ In the event of a change of ownership as described in IRC § 382(g), there is a limitation to the amount of the corporation’s net income in a post-change year which may be offset by an NOL from pre-change years. The limitation amount is the IRC § 382 limitation multiplied by the ratio of Massachusetts taxable net income to Federal taxable net income (See [830 CMR 63.30.2\(11\)\(b\)](#))
- ✓ Taxpayers may not carry forward and deduct losses incurred in years when they were not taxable in Massachusetts – see [M.G.L. c. 63 § 30\(5\)\(d\)](#)
- ✓ No provision exists to carry over capital losses

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## **10.8.2 Combined Group Members - Determining NOL Applicability**

### **Arriving at NOL of a Combined Group Member**

In order to determine each taxable member’s NOL (if any), the auditor must arrive at each taxable member’s post-apportionment taxable net income or loss. In this regard, each taxable member’s computed apportionment percentage is multiplied by the combined group’s income to determine each taxable member’s Massachusetts apportioned share. Shares of the combined group’s capital gains/losses and section 1231 gains/losses are determined as separately stated items from each taxable member’s other income or loss from the business.

Once each taxable member has determined its apportioned share of the combined group’s income or loss, it will add those separately stated shares and any other Massachusetts apportioned or allocated income it may have, adding other capital gains/losses to its apportioned share of capital gain/loss from the combined group. After determining its total capital gain/loss, section 1231 gain/loss and other income/loss as separate items, each taxable member will go through the “netting process” using the rules of IRC sections 1231 and 1222

without regard to any of the member's gains or losses that are allocated to another state. The end result of this netting process (which is performed and reported on Schedule U-ST) is such taxable member's post-apportionment taxable net income (or loss) for the year.

### **Generation of NOLs (Business Corporations)**

If the post-apportionment taxable net income is a loss, the member has an NOL which, if it is a business corporation, may be carried forward if it is otherwise allowable as provided under [M.G.L. c. 63 § 30.5](#). To the extent this loss includes a loss the member may have from sources other than the combined group's unitary business, it is subject to special handling as an NOL which may be used against any income of the taxpayer that actually incurred the loss (but it may not be shared).

Note: if there is an affiliated group election in the year the loss was incurred, any loss incurred will be considered a combined group loss.

### **Deduction of NOLs (Business Corporations)**

If the total post-apportionment taxable net income after the above netting process is greater than zero a business corporation may, to the extent it has an NOL available from a prior year, deduct the NOL subject to any limitations (see [9.6.3 Adjusting NOL Carryovers](#)).

## **10.8.3 Corporate Combined Reporting Group - NOL Audit Review**

### **Verify NOL Carried Forward against Original Return**

Taxpayers seeking an NOL deduction should provide an NOL schedule tracing losses claimed through the year in which the deduction was taken. This includes the original NOL amount, NOL amounts deducted in prior years and the NOL balance available for current year use. Each taxable year should be shown separately if there is more than one NOL available. The NOL schedule should become the audit review starting point.

The auditor should compare amounts shown on the taxpayer's NOL schedule as the original loss for each year with what was reported on the original return. The auditor must verify that the corporation claiming the loss actually incurred the loss since Massachusetts NOLs are not transferrable in a reorganization or absorbed in a merger (there are two exceptions – see (1) [LR 95-4](#) which concludes that a statutory merger which qualifies as an F reorganization under IRC §368(a)(1)(F) does not bar the corporation from taking the pre-reorganization net operating loss in a future year and (2) the transition rule at 830 CMR 63.30.3(4)(a)7. which transfers the tax attributes of a QSUB that was required to file separately in 2008 to its parent since it is no longer required to file a separate return in 2009).

Auditors should be alert for differences between the return filed by the corporation in the Loss Year (the year when the NOL was incurred) and the loss claimed and for short year returns in the intervening period indicating a merger or change in control which might invoke an IRC § 382 limitation issue. See [10.8.9 Limitation on NOL deduction – IRC section 382\(g\)](#).

**For periods beginning prior to January 1, 2009**, the auditor must first determine the post-apportionment loss from the schedule E filed with the return (this must be recomputed if an NOL deduction was taken on that return). Then, if the corporation claiming the loss carryover in the audit year filed a combined return under the previous version of section 32B for the Loss Year, the auditor must reduce the NOL by any portion of the loss used to offset income of any other members in that year.

**For years beginning after January 1, 2010**, post-apportionment loss is shown as a separate line item on the return (schedule E (or schedule U-ST if a combined report was filed)). This may also apply with respect to the 2009 taxable year if (a) the corporation was a taxable member of a combined group filing a combined report or (b) the corporation filed a separate form 355 schedule E and did not claim an NOL deduction on Schedule E, line 20. If such a deduction was taken on schedule E, the figures on that schedule must be recomputed without the NOL deduction taken to determine if there was an NOL to begin with and its amount.

**Verify Amount of any pre-2009 Loss Used within an “Old Style” Combined Return**

To determine the amount of a pre-2009 loss used within a combined return (as opposed to a combined report), the taxpayer must prepare a schedule for the auditor’s review showing the separately apportioned taxable net incomes of each member of the group for the year in which the loss was incurred. The post-apportionment losses of the members having NOLs are applied on a *pro rata* basis against the post-apportionment income of combined group members having positive apportioned taxable net income. If the total of the apportioned incomes and losses for the combined group’s members is greater than zero, all of the apportioned losses have been used. If the total of the apportioned losses exceeds the total of the apportioned incomes, the NOL available for carryover of each member that had one is reduced on a proportionate basis. A sample calculation reflecting this is below.

Member’s Name	Income or (Loss)	Apport. Percent	Apportioned Income/(Loss)	Losses Utilized	Post-Apport NOL remaining
Member A	(100,000)	20%	(20,000)	8,000	(12,000)
Member B	(50,000)	10%	(5,000)	2,000	(2,000)
Member C	200,000	5%	10,000	(10,000)	0

Under the pre-2010 NOL statute, the loss was carried forward on a pre-apportionment basis and the pre-apportionment loss available for Member A in the following year would have been (\$60,000). This is potentially significant if the taxpayer deducted a portion of the loss generated on a pre-apportionment basis in a subsequent year (for example, if the year shown above was 2007, Member A would have converted the loss back to a pre-apportionment amount of \$60,000 (\$12,000 divided by 20%). If Member A then deducted \$25,000 of this loss on a pre-apportionment basis in 2008, it would have had only \$35,000 or pre-apportionment loss remaining for 2009. If it subsequently wanted to take a deduction on a post-apportionment basis, the post-apportionment NOL available would have been \$7,000 = \$35,000 x 20% apportionment in the Loss Year).

There are two rare circumstances requiring special handling regardless of whether this was a post-2009 loss:

- (c) the taxpayer has claimed a deduction under some statutory provision other than M.G.L. c. 63 § 30.4 (the Net Operating Loss is defined with specific reference to those deductions).
- (d) The taxpayer has income that is allocated or separately apportioned and combined the amounts reflect a post-apportionment “loss”. Under MGL c. 63 § 30.5, a NOL occurs only where deductions exceed income.

### **Tracing the NOL**

Once the original loss has been verified by the auditor it should be traced to the current year. Corporations are required to carry over losses to the earliest succeeding taxable year in which they may be deducted (see the ordering rules at [830 CMR 63.30.2\(8\)](#)). The auditor should create or review a schedule provided by the taxpayer showing the taxable net income and the amount of any NOL deduction taken for each year starting from the Loss Year through to the current year. The NOL amount deducted in each subsequent year is subtracted from the NOL created in the Loss Year. Only amounts not previously deducted are available in the current year.

### **Example**

- 2012 Corporation M has a NOL of \$5,000 from the 2012 taxable year.
- 2013 Corporation M has taxable net income of \$1,000 and deducts \$1,000 of NOL.
- 2014 Corporation M has a loss in 2014 and generates another \$1,500 NOL.
- 2015 Corporation M has taxable net income of \$9,000 and deducts \$6,500 of NOL.  
Per the tracing analysis, this exceeds the total NOL available.  
Corporation M has 2 NOLs available for 2015 ... \$4,000 remaining from 2012 and \$1,500 from 2014. Its maximum allowable deduction would be \$5,500.

Corporation M is taking a \$1,000 NOL deduction in the 2013 year. Given the facts presented that deduction must be from the 2012 NOL (losses may only be carried forward), and the remaining NOL is \$4,000. In some cases, it is necessary to go back further beyond the year of the 1<sup>st</sup> NOL shown on the current year schedule to determine if the NOL deducted in an intervening year (2013 in the example) was from a still earlier period.

Adding the 2009, 2010 & 2011 years to the example produces a different result:

- 2009 Corporation M has a NOL of \$4,000 from the 2009 taxable year
- 2010 Corporation M has taxable net income of \$500 and deducts \$500 of NOL
- 2011 Corporation M has taxable net income of \$1,200 and deducts \$1,200 of NOL
- 2012 Corporation M has a NOL of \$5,000 from the 2012 taxable year

- 2013 Corporation M has taxable net income of \$1,000 and deducts \$1,000 of NOL
- 2014 Corporation M has a loss in 2014 and generates another \$1,500 NOL
- 2015 Corporation M has taxable net income of \$9,000 and deducts \$6,500 of NOL

This tracing analysis uses the loss from the 2009 tax year first.

- The \$4,000 NOL is reduced by \$500 to reflect the 2010 deduction and by \$1,200 for the 2011 deduction.
- There is \$2,300 of NOL remaining from the 2009 taxable year when the 2013 return is filed (in addition to the \$5,000 originating in the 2012 taxable year).
- The taxpayer's \$1,000 deduction in 2013 is from the 2009 NOL, leaving NOLs of \$1,300 from 2009 tax year and \$5,000 from the 2012 tax year available to carry forward.
- The 2009 NOL expires at the end of the 2014 tax year and is not available in 2015, but the taxpayer does have the \$6,500 claimed on the return (\$5,000 from 2012 and \$1,500 from 2014).

In some cases the loss must be reduced on a pre-apportionment basis by deductions taken on a pre-apportionment basis and then converted to a post-apportionment amount for 2010 (for 2009 if a combined report was filed).

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#### **10.8.4 Corporate Combined Reporting Group - Sharing of NOL Carry Forwards**

If a business corporation which is a taxable member of a combined group has an NOL that exceeds its apportioned income for the year, it may share the excess available loss with another member of the group as described in 830 CMR 63.32B.2(8)(b). A loss may be shared with another member of the group provided the following conditions are met:

- ✓ The corporation generating the loss must take its own NOL deduction first. A corporation may not choose to share a loss in place of deducting the NOL against its own income
- ✓ The ordering rules require the member with more than one available NOL being carried forward to take the oldest loss first
- ✓ It is permissible, for example, for a member with losses available from 2012, 2013 and 2014 to deduct the losses from 2012 and 2013 from its own income and then share any remaining losses from later years with other members of the group

- ✓ In order to share any remaining losses from later years with other members of the group, the NOL must be from a year in which the corporation that incurred the NOL filed a combined report and the NOL must be from the taxpayer's MA apportioned share of a combined group loss (e.g., if a member has a loss from a separate business activity, that loss may not be shared)
- ✓ A member with an NOL which includes both its apportioned share of the group's loss and a separate loss from a year in which an affiliated group election was not made, may share that portion of the NOL which is derived from group activities
- ✓ The member seeking to deduct the shared NOL must take any available NOL of its own first (i.e., a member may not choose to forego its own NOL deduction in order to take a shared one)
- ✓ The member seeking to deduct a shared NOL may only take a deduction against its apportioned share of combined group income in the current year (i.e., a member with allocable income may not reduce it by deducting a shared NOL)
- ✓ Both the member with the tax attribute (the NOL) and member taking the deduction must have been included (1) in the same combined group (2) in the same year in which the loss was incurred and (3) in the same year in which it was shared
- ✓ Excess NOL carry forward may not be shared with either a financial institution or a pre-2014 utility corporation
- ✓ In all cases, the use of NOL carry forwards by other taxable members of the combined group must be consistent with the requirements and limitations that generally govern the use of NOL carry forwards including the requirement that oldest NOLs must be utilized first
- ✓ Any amount of NOL carry forward that is subsequently deducted by any taxable member of a combined group must reduce the amount of NOL that may subsequently be carried forward by the taxpayer that originally generated the NOL

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### **10.8.5 When Owner of NOL Carry Forward Leaves Combined Group**

Auditors must verify the owner(s) of available NOL carry forwards and ensure that proper sharing and application of such NOL carry forwards occurs as required. Auditors must also verify that the appropriate rules have been followed in situations where the owner of available NOL carry forwards ceases to be a member of the combined group. [830 CMR 63.32B.2\(8\)\(c\)](#).

Under the combined reporting regulation, NOL carry forwards must be carried forward from year to year separately by the individual taxpayer that originally incurred the underlying loss and thereby remain the tax attribute of that member (although such carry forwards may be shared with other taxable members of a combined group-see [10.8.4 Corporate Combined Reporting Group - Sharing of NOL Carry Forwards](#) above):

- ✓ Where a taxable member of a combined group ceases to be a member of the combined group, for whatever reason, any NOL carry forward owned by such taxpayer is no longer available for use by the other taxable members of the combined group with which the taxpayer was previously affiliated
- ✓ If the taxpayer becomes a member of a new combined group it may not share the NOL carry forward with the taxable members of the new combined group unless one of the taxable members of the new combined group was also a member of the taxpayer's combined group during the year the loss was incurred and all other requirements for sharing NOLs with other taxable members are met
- ✓ Where a taxpayer having an NOL carry forward becomes a member of a new combined group, the change of ownership rules of IRC § 382 (as applied under MA law) may apply (however, any amount of NOL carry forward that cannot be applied because of section 382 limitations may still be carried forward consistent with 830 CMR 63.32B.2(8)(c)- see 830 CMR 63.30.2(11))
- ✓ Where a member of a combined group has an NOL carry forward and subsequently takes part in a merger or consolidation, the NOL carry forward will be lost if, for example, the member liquidates or terminates as a result of the merger or consolidation-see 830 CMR 63.30.2(11)

#### **10.8.6 Pre-2009 NOL Carry Forwards of Taxable Member of Combined Group**

Auditors verifying combined group NOL carry forwards must be aware that, where a combined group taxable member has an NOL carry forward from a loss in a taxable year beginning prior to January 1, 2009, the NOL carry forward remains available for that taxpayer in a subsequent tax year to the extent it was allowed under the MA law that was in effect during the year the loss was incurred (subject to the NOL limitation set forth in 830 CMR 63.32B.2(8)(f) - see 10.8.8 Special Rule - Pre-Combination NOL in a Combined Report).

In such cases the following must be verified by the auditor:

- ✓ Verify that NOL carry forwards of this type have only been deducted by the taxpayer which incurred the loss (it cannot be shared by the taxpayer with the other taxable members of the combined group)
- ✓ Since neither a financial institution nor a pre-2014 utility corporation was entitled to an NOL carry forward prior to January 1, 2009, those taxpayers cannot carry forward

an NOL derived from a loss incurred for a taxable year beginning prior to January 1, 2009

- ✓ For taxable years beginning prior to January 1, 2009, a taxpayer's NOL carry forward was to be "grossed up" to reflect a pre-apportionment calculation by dividing the amount of any unused loss by the taxpayer's apportionment percentage from the year in which the loss was incurred. However, to apply such a carry forward to apportioned income derived from the activity of a combined group for a taxable year beginning on or after January 1, 2009, the taxable member of the group must first convert the NOL carry forward to a post-apportionment calculation. Verify that these calculations were correctly performed

Examples:

- ⇒ Where there is an NOL carry forward derived from a loss incurred in a taxpayer's 2008 taxable year, the taxable member of a combined group must carry forward the loss to its 2009 taxable year on a 2008 post-apportioned basis
- ⇒ Where there is an NOL carry forward derived from a loss incurred in the taxpayer's 2007 taxable year or earlier, any remaining carry forward from such year(s) must be multiplied by the taxpayer's apportionment percentage from that year for purposes of being carried forward by the taxpayer to its 2009 tax year (or thereafter)

See 830 CMR 63.32B.2(8)(d).

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### **10.8.7 NOL Carry Forwards Generated Prior to Combined Group Inclusion**

The auditor must also consider situations addressed under the combined reporting regulation where a new group member enters an existing combined group:

- ✓ Where a corporation not previously a member of a combined group enters a pre-existing combined group or becomes part of a new combined group with one or more other corporations, the corporation may continue to deduct any NOL carry forwards from prior taxable years against its apportioned income derived from the combined group (subject to the IRC section 382 limitation set forth in 830 CMR 63.32B.2(8)(f))
- ✓ However, the taxpayer's pre-combination NOL carry forward was to be "grossed up" to reflect a pre-apportionment calculation (by dividing the amount of any unused loss by the taxpayer's apportionment percentage from the year in which the loss was incurred)

- ✓ To apply such a carry forward to apportioned income derived from the activity of a combined group for a taxable year beginning on or after January 1, 2009, the taxable member of the group must first convert the NOL carry forward to a post-apportionment calculation (by multiplying the remaining NOL carry forward from any individual pre-combination year by the taxpayer's apportionment percentage from that pre-combination year)

[See 830 CMR 63.32B.2\(8\)\(e\).](#)

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### 10.8.8 Special Rule - Pre-Combination NOL in a Combined Report

The use of NOL carry forwards by a taxpayer that incurred the loss prior to mandatory combined reporting is subject to a limitation to prevent, among other things, a combined group that includes such member from transferring MA property or payroll to that member to enhance the post-apportionment value of such member's loss. See 830 CMR 63.32B.2(8)(f). This limitation restricts the loss corporation's post-apportioned NOL carry forward by applying the in-state apportionment factors of such corporation that existed at the time that the loss was incurred, with an election allowed for use of the loss to be greater in certain cases where the loss corporation progressively increases its in-state Massachusetts property or payroll apportionment factors subsequent to the time of the loss. This election is intended to permit the NOL carry forward limitation to be less restrictive for a growing company.

To determine the maximum amount of NOL that may be deducted from its apportioned share of group income the corporation will use:

- (1) its numerators from the year in which the loss was incurred (in dollars) and the combined group's income;
- (2) its denominators from the current year and
- (3) its apportionment formula in the current year

#### Example:

			Apportionment Percentage	Current Year Combined Income	Limit on Pre- combination NOL
Prior Year Property Factor Numerator	50,000	=			
Current Year Combined Property Factor Denominator	1,000,000				
			.050000		
Prior Year Wage Factor Numerator	10,000	=			
Current Year Combined Wage Factor Denominator	100,000				
			.100000		
Prior Year Sales Factor Numerator	125,000	=			
Current Year Sales Factor Denominator	1,000,000				
			.125000		
Total Apportionment Factors (Prop + Wage + 2x Sales)		=	.400000	= .100000	x \$80,000
					= \$8,000

Note: if the taxpayer had been a section 38 manufacturer in the current year, the apportionment percentage for this purpose would have been 12.5% regardless of whether or not the taxpayer was a manufacturer in the prior year.

In calculating the limitation, taxpayers must reduce the sales factor numerator from the prior year to exclude any throwback sales shipped to any state that is not subject to throwback in the current year. For example, if the taxpayer was not separately taxable in Texas in the year the loss was incurred and \$50,000 of sales were thrown back to Massachusetts in that prior year, but either (a) the taxpayer is taxable in Texas for the current year or (b) another member of the combined group is taxable in Texas in the current year, the numerator for this calculation would be reduced to \$75,000 (\$125,000 - \$50,000).

The regulation requires that where a corporation has losses from more than one pre-combination year the numerators from those years are combined on a weighted average basis. The combined group is also given the option (*see* 830 CMR 63.32B.2(8)(f)2.) to elect to adjust all of the numerators used in this calculation by the ratio of the overall growth in the combined group's property and payroll in Massachusetts from the loss year to the current year. If the taxpayer makes this election, this must be done for all members of the group making this calculation.

The limitation of a taxable combined group member's use of its pre-combination NOL carry forwards where such member's losses were incurred when it was subject to a different apportionment methodology than its current tax year is explained in detail in [Department Directive 10-5 \(item IV\)](#).

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#### **10.8.9 Limitation on NOL deduction – IRC section 382(g) “Ownership Change”**

Where there is an “ownership change” under IRC § 382(g), the amount of income from a “post-change year” that may be offset with an NOL from a “pre-change year” is limited. This rule does not prohibit a corporation from using a post-change NOL to offset income not reached by a pre-change NOL. Thus the auditor should consider a possible ownership change when reviewing an NOL deduction in the context of a combined corporate audit. This is discussed in greater detail in [9.6.2 IRC section 382\(g\)-Limitation on Income Subject to Offset by NOL Carry forward](#).

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#### **10.8.10 Relationship of Allocable & Other Apportionable Losses with NOL Carry Forwards**

An allocable loss (*see* M.G.L. c. 63, § 38(b)) or allocable loss carry forward is determined for each individual taxpayer on a separate company basis. This is separate and apart from the combined group's taxable income or loss determination. In such situations, the auditor must verify that a taxpayer with an allocable loss or allocable loss carry forward has properly treated such loss in

accordance with the applicable combined reporting regulation rules:

- ✓ A combined group member with an allocable loss or allocable loss carry forward may offset that loss first against its allocable income and then against its post-apportioned income derived from a combined group
- ✓ An allocable loss or allocable loss carry forward is a separate company loss that can only be used by the taxpayer that incurred the loss and cannot be shared; thus a taxpayer with an allocable loss to carry forward must carry forward that allocable loss separately from a post-apportioned NOL carry forward derived from the activities of a combined group
- ✓ Similarly, if a combined group member has an apportioned loss from business activities other than from the activities of a combined group, this loss and any loss carry forward resulting therefrom is a separate company loss and may only be used by the taxpayer that incurred the loss and cannot be shared
- ✓ Generally a taxpayer must apply its oldest carry forward losses first irrespective as to whether they are derived from a separate company loss (allocated or apportioned) or from an apportioned loss derived from the activities of a combined group; however, with respect to any tax year from which the taxpayer has both a separate company loss carry forward and an apportioned loss carry forward derived from the activities of a combined group, it must apply the separate company loss carry forward first against separate company income (and *vice versa*)

See [830 CMR 63.32B.2\(8\)\(g\)](#).

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#### **10.8.11 Combined Group NOL Carry Forward Examples (830 CMR 63.32B.2(8)(I))**

There are a number of detailed combined group NOL examples in the combined reporting regulation to which auditors should refer when they are in the process of verifying combined group NOLs and carry forwards. The examples also provide specific citations from which the auditors may gain additional insight. See [830 CMR 63.32B.2\(8\)\(h\)](#), Examples 1. through 7.

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## 10.9 Corporate Combined Reporting Group – Credits (830 CMR 63.32B.2(9))

Any combined group member entitled to tax credits may take them against their respective excise on the combined report. Except as specified below, the use of a combined report to determine the combined group member's taxable net income and to report its tax liability on that income, or for other taxes it may have due, has no effect on its eligibility for (or limitations on) tax credits. The various credits available to business corporations, the taxpayers eligible to receive tax credits, credit recapture and other issues that may frequently be encountered on audit with respect to tax credits are outlined in [Section 9.8 Credits](#).

For auditors reviewing a combined report, additional focus is required on the sharing of tax credits among the combined group members. The combined reporting regulation sets forth specific rules (and exceptions) which should guide the auditor in verifying whether a combined group member has properly utilized and shared eligible tax credits with other combined group members of the combined group. See [830 CMR 63.32B.2\(9\)](#).

### 10.9.1 Sharing of Credits within a Combined Group

Each combined group member may use its own credits to the extent allowed by law. When a taxable member has excess credits after it has used any that may be used against its own excise it may then share those credits with other taxable members of the combined group subject to certain limitations:

- ✓ The combined group member which generated the credits must take its own credits first. A combined group member with multiple credits available may generally choose to use one credit instead of another (e.g., the combined group member may elect to use section 31A Investment Tax Credits (ITC) over Vanpool Credits if both are available)
- ✓ A credit may be applied against a combined group member's income or non-income measure. However, under no circumstance may a general business corporation reduce its excise to less than the minimum corporate excise amount
- ✓ If the combined group member has more credit than it may use against its own excise, the excess credit may be applied against the excise of other taxable members that are eligible to share the credit consistent with the requirements and limitations applying to such credit; provided, however, that each of other taxable members must first use their own credits including any credits carried forward from prior years
- ✓ Recall that in applying and sharing credits the ITC and the Economic Development Incentive Program (EDIP) credits are each subject to a 50% annual limitation and

the Research Credit is subject to a 75% annual limitation (i.e., the credit may not reduce the taxpayer's excise for the year by more than 50% or 75%, respectively, although the first \$25,000 of the research credit it is not subject to any percentage limitation)

- ✓ When a Research Credit is generated by a combined group member for taxable years beginning on or after January 1, 2009 it may be applied against the excise due from one or more other combined group members if the credit derives from the unitary business of such group and the other combined group members are corporations taxable under M.G.L. c. 63 sections 39 or 32D
- ✓ The tax credits must be from a year in which the combined group member that has them filed a combined report that also included the other member(s) seeking to use the credits, and the credits must be attributable to the combined group's unitary business (if an affiliated group election was made in that year, all of the credits will be attributable to that business)
- ✓ Where an affiliated group election has been made, a credit validly claimed by a combined group member may be shared with the other taxable members of such group irrespective as to whether the combined group members sharing the credit are all engaged in a unitary business to the extent such sharing of the credit is consistent with the statutory requirement for claiming the credit as addressed in 830 CMR 63.32B.2(9)(a)
- ✓ The combined group member seeking to use the credits must be eligible to take the credits (e.g., a financial institution is not eligible to take a research credit and so may not share one from another combined group member)
- ✓ The combined group member seeking to use the credits may not exceed any statutory limitations on its use (i.e., no combined group member may take a greater amount of credit under the combined group sharing rules than it could take if the credit were its own)

Note: There are three (3) exceptions relating to these general rules:

- 1) 830 CMR 63.32B.2(9)(a) – a combined group member that is not a manufacturing corporation but which is required to use single sales factor to apportion its income under 830 CMR 63.32B.7(g)(2)d. may also share section 31A ITC from another group member - it may not receive ITC with respect to its own assets. All other restrictions on sharing the credit remain in effect
- 2) 830 CMR 63.32B.2(9)(c)2. – a combined group member with pre-2009 credit that could have been shared prior to combined reporting (generally,

this is limited to research credit under section 38M and the EOA credit under the pre-2010 version of section 38N) may share that credit with any corporation with which it could have shared the credit when filing its 2008 return (it must have filed a return under the prior version of M.G.L. c. 63 §32B with the corporation that now seeks to take the credit). All other restrictions on sharing the credit remain in effect; and

- 3) A credit represented by a certificate that is freely transferrable may be shared within a combined group regardless of the year to which it relates or whether or not it derives from the combined group's common business without requiring the combined group member to apply for a transfer of the credit. The combined group member that is the nominal owner of the credit (1) must still use credits to reduce its own excise first, (2) the corporation that seeks to share the credit must be eligible to take it and (3) any statutory limitation on the credit continues to apply

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### **10.9.2 Combined Group - Carry Forward of Post-2009 and Pre-2009 Credits**

Generally when a taxpayer does not use the full amount of a credit generated in a taxable year it may carry forward the amount of credit not used in a manner consistent with the statutory requirements for applying the credit. While carry forward of post-2009 and pre-2009 combined group member tax credits was generally discussed above, the auditor should nevertheless be aware that the combined reporting regulation specifically addresses these situations, including providing examples applying the specific rules relating to carry forward of post-2009 and pre-2009 credits. [830 CMR 63.32B.2\(9\)\(c\)](#).

#### **Post-2009 Credits**

Where a combined group member generates a credit for a taxable year beginning on or after January 1, 2009, it may carry forward the portion of such credit not taken by it or by the other members of the combined group.

Any credit carried forward may only be shared with a member of the current year combined group that:

- ⇒ was a member of the combined group during that current year (i.e., the tax year beginning on or after January 1, 2009) that the credit was generated; or
- ⇒ is a successor (in whole or in part) to one or more combined group members from such prior post-2008 tax year such that there is 100% continuity of ownership as between the successor corporation and one or more corporations that were in the combined group during such prior (post-2008) tax year

See [830 CMR 63.32B.2\(9\)\(c\)1](#). and Examples 2 through 4.

### **Pre-2009 Credits**

When a credit is generated by a combined group member for a taxable year beginning prior to January 1, 2009, a credit carry forward may be applied in a subsequent tax year consistent with the statutory rules that applied to such credits in the year the credit was generated.

- ✓ Therefore, in tax years beginning on or after January 1, 2009 such a credit carry forward may be shared by the combined group member that generated the credit with one or more taxable members of its combined group only if:
  - 1) sharing is consistent with statutory rules applying to the credit in the year the credit was generated and
  - 2) such statutory rules required filing of a combined return of income (not a combined report) under the previous version of M.G.L. c. 63, § 32B in order for the credit to be shared and
  - 3) only if the combined group member that generated the credit and the other members seeking to share the credit jointly filed a combined return for a tax year beginning prior to January 1, 2009

Example - a carry forward of a research credit generated by a combined group member for a taxable year beginning prior to January 1, 2009 may be applied against the excise due from one or more other combined group members if the credit relates to the group's unitary business and the other taxable members seeking to share the credit and the taxable member that generated the credit filed a combined return for a tax year beginning prior to January 1, 2009.

Conversely, since an ITC credit could not be shared by corporations in tax years beginning prior to January 1, 2009, a credit carry forward of an ITC credit still cannot be shared by combined group members in taxable years beginning on or after January 1, 2009.

See [830 CMR 63.32B.2\(9\)\(c\)2.](#) and Example 5.

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### **10.9.3 When Owner of Credit Leaves Combined Group**

A tax credit or credit carry forward remains the property of the combined group member that initially generated it regardless of whether such credit or credit carry forward may be shared among the taxable members of a combined group. Auditors must trace out credits generated by combined group members who cease to be affiliated with a combined group or take part in a merger or consolidation and verify that any credit carry forwards terminate or are no longer available for use by the other combined group members (or if any specific exception may apply):

- ✓ if for whatever reason a taxable member of a combined group ceases to be a member of the combined group, any credit carry forward owned by such combined group member is no longer available for use by the other combined group members with which the owner of the credit carry forward was previously affiliated

- ✓ if the combined group member becomes a member of a new combined group, the combined group member may not share the credit with the taxable members of its new combined group unless:
  - ⇒ one of the taxable members of the new combined group was also a member of the member's combined group during the year that the credit was generated and
  - ⇒ all the other requirements set forth in 830 CMR 63.32B.2(9) for sharing of the credit are met
  
- ✓ if a combined group member with a credit carry forward becomes a member of a new combined group, the IRC section 383 change of ownership rules (as applied under MA law) may apply (though any amount of credit carry forward that cannot be applied because of IRC section 383 limitations may be carried forward consistent with the rules and limitations discussed in 830 CMR 63.32B.2(9)(c))
  
- ✓ In the event a combined group member has a credit carry forward and subsequently takes part in a merger or consolidation, the credit carry forward will be lost if, for example, the member liquidates or terminates as a result of the merger or consolidation - *but see [Comm'r of Revenue vs. The Gillette Co.](#), 454 Mass. 72 (2009)*(tax-free liquidation of all assets by wholly-owned subsidiary into parent did not result in a "disposition" of assets triggering ITC recapture); [TIR 10-22: Commissioner of Revenue v. The Gillette Company: No Disposition of Qualifying Property for Purposes of the Investment Tax Credit](#)
  
- ✓ When an S Corporation and a QSub were treated as a single corporation (by reason of St. 2008, c. 173) for tax years beginning on or after January 1, 2009, the credit carry forward of the S corporation and/or the QSub must also be treated as the credit carry forward of a single corporation - see 830 CMR 63.30.3

See [830 CMR 63.32B.2\(9\)\(d\)](#) and Examples 6 and 7.

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#### **10.9.4 Recapture of ITC and EOAC/EDIP Credits; Recapture Generally**

Auditors must verify whether and if ITC, EOAC/EDIP and other tax credits are subject to credit recapture and, if so, whether the recapture tax has been correctly calculated. As discussed above, the various tax credits and applicable tax credit recapture issues are generally outlined in [Section 9.8 Credits](#). However, auditors must also understand and apply certain rules that are specific to recapture tax issues in the context of a corporate combined reporting audit and, in particular, those set forth in the combined reporting regulation:

- ✓ When a combined group member generates an ITC or EOAC/EDIP credit for a taxable year beginning on or after January 1, 2009 and then subsequently disposes of the property, or where the property otherwise ceases to be in qualified use within the meaning of the applicable ITC or EOAC/EDIP credit statutes, credit recapture must be determined (pursuant to M.G.L. c. 63 § 31A) based upon the total credit previously taken by the combined group member and its combined group members

Note: This rule applies even if the combined group member first leaves the combined group then in a subsequent year disposes of the qualified property or otherwise causes recapture, and as such the combined group member would no longer be included in a combined group where other members' use of the credit would be considered for purposes of recapture

- ✓ Where a combined group member generates an ITC or EOAC/EDIP credit for a taxable year beginning on or after January 1, 2009, there is no recapture if the combined group member subsequently transfers the qualified property to another taxable member of its combined group with which the credit could be shared under the rules in 830 CMR 63.32B2(9)
- ✓ However, if the transferee of the qualified property (i) leaves the combined group or (ii) subsequently transfers the property outside the combined group (or to a member of the combined group with which the credit cannot be shared under the rules in 830 CMR 63.32B2(9)), there must be recapture of the credit (pursuant to M.G.L. c. 63, § 31A) on the part of the combined group member that generated the credit in a manner which is based upon the total credit previously taken by the combined group members
- ✓ In any other case where a MA tax credit that is subject to recapture can be shared among combined group members, the recapture of such tax credit shall be evaluated in a manner similar to that which is applied with respect to the recapture of the ITC or EOAC/EDIP credit pursuant to M.G.L. c. 63, § 31A

See [830 CMR 63.32B.2\(9\)\(e\)](#) and Examples 8 and 9.

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## 10.10 Massachusetts Affiliated Group Election (830 CMR 63.32B.2(10))

As mentioned earlier (see [10.2.3 Corporate Combined Reporting - Group Election Options](#)), the taxpayer can make a voluntary election to report the income of the Massachusetts affiliated group (as defined in 830 CMR 63.32B.2(2)) in lieu of having to determine which corporations are members of the unitary business for purposes of participating in the filing of the combined report. The election does not require the Commissioner's consent. An affiliated group election is only permitted where: (i) a combined report is otherwise required, and (ii) the combined group includes at least one group of corporations that are required to file a consolidated federal tax return for the year in which such election is made.

Once an affiliated group election is made, all of the affiliated group member corporations are treated as members of a single Massachusetts combined group irrespective of whether all of these corporations are (i) included in more than one federal consolidated return filed by more than one federal consolidated group; or (ii) engaged in one or more unitary businesses. See [830 CMR 63.32B.2\(10\)\(a\)](#).

A Massachusetts affiliated group must calculate the combined group's taxable income and the respective taxable income of the taxable members of the group in accordance with 830 CMR 63.32B.2(6) and (7) (see [10.6 Corporate Combined Reporting - Taxable Income](#) and [10.7 Corporate Combined Reporting Group Income Apportionment](#)).

Note: Massachusetts affiliated groups constitute approximately 30% of combined reporting filers. Auditors must therefore assume that they will often encounter combined reporting groups making this affirmative election.

### 10.10.1 Affiliated Group Election-Duration, Revocation and Renewal

An affiliated group election is binding for the year in which it is made and for the next 9 taxable years. An affiliated group election may not be made if there is a worldwide election currently in effect. [830 CMR 63.32B.2\(10\)\(b\)](#). If a prior affiliated group election is neither affirmatively revoked nor renewed after ten taxable years pursuant to 830 CMR 63.32B.2(10), the election terminates for the next taxable year and no affiliated group election applies for that year and the next two taxable years. The former affiliated group can make a new election for a ten taxable year period after the required 3-year waiting period. [830 CMR 63.32B.2\(10\)\(f\)](#).

Note: As mentioned above, once a worldwide or affiliated group election is made it is irrevocable and binding for a total of ten (10) taxable years after which the default "water's edge" rules will apply, unless a new group election is made or the election is renewed by the taxpayer. Auditors must verify the validity of the combined group's status, including any election, the duration of the election and whether it is still valid and in effect or has been renewed. In addition, auditors should verify that the taxpayer abided by the 3-year waiting period for renewing an affiliated group election when the election was not revoked or renewed.

### **10.10.2 Affiliated Group Election-Interaction with “Water’s Edge” Filing Requirement**

The types of corporations that are generally included in a “water’s edge” combined report (e.g., certain non-U.S. corporations) are also included in a group under an affiliated group election. The only difference is that such corporations are only included by virtue of a common ownership standard, not by virtue of the unitary business standard which is part of the “water’s edge” filing requirement. Conversely, the types of corporations that are not generally included in a combined report (e.g., certain non-US corporations, certain insurance companies and security corporations) are also not included under an affiliated group election.

When an affiliated group election is made, each member’s federal gross income and related deductions (as determined under the Code) are considered in the calculation of the affiliated group’s taxable income. Similarly, items added to gross income by application of Massachusetts law (e.g., interest on state bonds) are also includible in calculating the affiliated group’s taxable income. There is no determination whether any of the members’ income or expenses is “non-unitary” under an affiliated group election, since the unitary business standard does not apply and all income of the group is apportionable (i.e., there is no non-business income in an affiliated group). As noted above, one or more non-US corporations may also be included in the affiliated group if such entities would otherwise be included in a water’s edge combined report and such entities are under common ownership (i.e., they would be included regardless of whether such corporations are engaged in a unitary business).

#### **Affiliated Group Election-Interaction with M.G.L c. 62C § 3A**

There is a specific rule of abuse in the combined reporting regulation that applies where an affiliate group election would not have “meaningful continuing application.” In such cases, the Commissioner may disregard the tax effects of such an election pursuant to M.G.L. c. 62C, § 3A. See [830 CMR 63.32B.2\(10\)\(h\)](#).

### **10.10.3 Affiliated Group Election-Agreement to Provide Documents**

An affiliated group election constitutes the taxpayer’s consent to the production of documents or other information that the Commissioner reasonably requires. See [830 CMR 63.32B.2\(10\)\(i\)](#). Example – in the event a taxpayer is reluctant to voluntarily provide supporting documentation in the course of the audit review, the auditor may invoke this provision for purposes of (among other things) verifying the appropriate members of the group, that the requirements of the affiliated group election have been met, that tax computations and reporting are proper, and for purposes of determining the revenue implications resulting from the affiliated group election.

See [10.2.3 Corporate Combined Reporting - Group Election Options](#).

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## 10.11 Relation of Non-Income Measure to the Combined Report

Business corporations (but not Financial Institutions or Utility Corporations) are subject to a non-income measure of excise based on their taxable tangible property or their apportioned taxable net worth. The procedures for auditing the non-income measure of a business corporation are more fully addressed in [section 9.7](#) and auditors should refer to them there. This section is devoted to the relation of the non-income measure to the combined report, and how auditors should verify the non-income measure when auditing a combined report.

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### 10.11.1 Section 32B Not Applicable to Non-Income Measure

Initially it is important to note that [M.G.L. c. 63 §32B](#) applies to the calculation of taxable net income from the combined group's unitary business (or, upon election, from the combined income of the affiliated group). A taxable member determines its income measure of excise when filing the combined report by following section 32B.

Section 32B does not affect the determination and calculation of any other taxes the taxpayer may owe, including the non-income measure. Each taxpayer must separately determine its non-income measure of excise when participating in a combined report, and this result is not affected by a combined group election.

None of the modifications to income or apportionment specifically required by the combined reporting regulation apply to the calculation of an apportionment percentage for purposes of classifying the taxpayer as a tangible or intangible property corporation or in determining the apportioned share of net worth. See [830 CMR 63.32B.2\(6\)\(b\)3](#). This includes (but is not limited to) the following:

- a) the use of combined group denominators for the group is not applicable when computing the non-income measure (each corporation's denominators include only its own activities), and
- b) the elimination of intercompany sales for both income and apportionment purposes under the combined reporting regulation is not done for non-income measure calculations, and
- c) the requirement that a corporation selling property manufactured by an affiliate use the single sales factor to apportion under certain circumstances does not apply.

The combined group determines its combined income on the basis of a common taxable year. Any corporation required to file a return in Massachusetts which ends its separate taxable year at the same time as the common taxable year of the combined group will pay the non-income measure of excise and any other taxes it may owe (including any applicable minimum excise). These other taxes are shown on Schedule U-ST of the combined report.

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### **10.11.2 Nexus and the Non-Income Measure**

Note: the non-income measure applies to a corporation doing business in Massachusetts even if that corporation is not subject to an income measure pursuant to federal [Public Law 86-272](#) (15 U.S.C. § 381)(see the last paragraph of [M.G.L. c. 63 § 39](#)). Auditors must therefore verify the reporting basis of each non-taxable member participating in a combined group to ensure they are correctly determining the non-income measure of the corporate excise as a non-taxable member. A business corporation member with nexus in Massachusetts which is exempt from the income measure of excise under PL 86-272 will file a schedule U-ST and report the tax on its taxable tangible property or net worth with the Form 355U. [M.G.L. c. 63 § 39](#).

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### **10.11.3 Reporting the Non-Income Measure in a Combined Group**

For 2009 and 2010, combined group members subject to the non-income measure filed a separate tax return to pay that portion of the excise. From tax year 2011 forward, the non-income measure component is incorporated within the combined return form. Therefore, aside from addressing scenarios involving fiscalization (see [section 10.12.3](#) below), the filing of a separate return by a combined group member to calculate the non-income measure is no longer required.

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## **10.12 Other Corporate Combined Reporting Provisions (830 CMR 63.32B.12)**

The combined reporting regulation addresses a number of situations which are not typically encountered in the filing of a standard combined report. Auditors must verify that these special circumstances have been addressed when performing an audit review and must apply additional rules or make any additional audit adjustments necessary to reflect these scenarios. [830 CMR 63.32B.12](#).

### **10.12.1 Recalculation, Recapture, Other Taxes and Credits**

Corporations may also be subject to recapture tax (as discussed in section [9.8.2 Recapture Taxes](#) and [10.9.4 Recapture of ITC and EOAC/EDIP Credits; Recapture Generally](#)) and other, less common taxes imposed by various provisions of law (e.g., the additional tax on certain large installment gains under [M.G.L. c. 63 §32A](#), the entity level tax imposed on S Corporations where an entity level tax is imposed under the Code, etc.). These taxes are also reported on each taxable member's Schedule U-ST.

The auditor must verify that each taxable member has properly recalculated their respective corporate excise amount including limitations on the use of any credits, the corporate excise tax

calculation for each member, recapture taxes (if any) and any other taxes and credits which may apply.

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### **10.12.2 Taxable Year ([830 CMR 63.32B.2 \(12\)\(b\)](#))**

#### Taxable Year - General Rule

A combined group's taxable year is determined by using the taxable year of the principal reporting corporation unless two or more members of the group file a federal consolidated return, in which case the group's taxable year would be the taxable year of the federal consolidated group. In the case where the members of the combined group file more than one federal consolidated return, the taxable year of the federal consolidated group with the most total assets would be the combined group's taxable year. [830 CMR 63.32B.12\(b\)\(1\)](#).

#### Taxable Year - 52 to 53 Week Tax Years

Where a corporation files federal income tax returns on the basis of an annual period which varies from 52 to 53 weeks, its taxable year shall be treated as beginning with the first day of the calendar month beginning nearest to the first day of such taxable year, or ending with the last day of the calendar month ending nearest to the last day of such taxable year. See [M.G.L. c. 63, § 30\(12\)](#); [830 CMR 63.32B.12\(b\)\(2\)](#).

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### **10.12.3 Fiscalization ([830 CMR 63.32B.2 \(12\)\(c\)](#))**

Though rarely encountered, one or more business corporation members of a combined group may have a taxable year that ends at a different time from the group's taxable year (e.g., an S Corporation which files on a calendar year basis owns a C Corporation subsidiary with a fiscal year ending in June). In such cases, the member determines its income for the common taxable year and that amount is included when the income or loss of the combined group is determined for the common year. [830 CMR 63.32B.12\(c\)](#).

If such a "fiscalized" member is a taxable member, it will determine and pay its income measure of excise on its apportioned share of the combined group's income on Schedule U-ST at the time Form 355 is filed. Any other taxes owed by such "fiscalized" member (including the non-income measure of excise of excise and/or the minimum excise) are paid on a separate tax return filed at the close of such "fiscalized" member's own tax year.

#### Requirement of Separate Non-Income Measure Filing by Fiscalized Member

From 2011 forward the non-income measure component has been incorporated within the combined return. As a result, the filing of a separate return by a combined group member to calculate the non-income measure is no longer required. However, any taxable member whose taxable year does not end in the same month as the common taxable year of the combined group (i.e., a "fiscalized" member) must still separately calculate its non-income measure (and any

other taxes due) on a separately filed return.

### **Checklist – Methods for Calculating Fiscalized Member’s Share of Combined Group Income**

Auditors must verify that the correct calculation method is followed when combined group members do not all file on the same tax year. The following checklist should help the auditor verify that a “fiscalized” member has properly calculated its share of the combined group’s income:

- ✓ First - Verify Common Taxable Year - the common taxable year is either of:
  - ⇒ The year used for the filing of the federal consolidated return, or
  - ⇒ If there is no federal consolidated return, then the year used by the principal reporting corporation
  
- ✓ Second – Verify Alignment of Income and Factors to Common Taxable Year - any “fiscalized” member should determine its income and apportionment data for the combined group taxable year by using either the default interim closing method or the alternative pro rata method
  
- ✓ Default Interim Closing Method (830 CMR 63.32B.2(12)(c)2.a.) – this “default” method requires an interim closing of the books for “fiscalized” members. The unitary business or affiliated group income or loss attributable to a combined group member is determined:
  - 1) by calculating the income (or loss) from the books and records of the “fiscalized” member for the two periods that together encompass the combined group’s single taxable year
    - Example - if the combined group has a taxable year ending on December 31, 2009 and another member has a taxable year ended March 31, 2010, that “fiscalized” member determines its income from its books and records for the partial accounting periods beginning January 1, 2009 and ending March 31, 2009 and from April 1, 2009 and ending December 31, 2009
  - 2) the “fiscalized” member’s apportionment is also determined by reference to the member's books and records for the same partial taxable year; however
  - For the property factor the average property owned is required to be determined using monthly averaging (*see* 830 CMR 63.38.1(7)(e)3)
  - 3) interim income and apportionment from the partial tax years is combined with the income and apportionment of the combined group’s taxable year (along with income and apportionment of other members of the combined group) and
  - 4) the members’ share of the combined group’s taxable income for the combined group’s tax year is then computed
  
- ✓ Alternative Pro Rata Method (830 CMR 63.32B.2(12)(c)2.b.) – the taxpayer’s use of an alternative pro rata method of converting income to the combined group’s taxable year

may be accepted in certain instances provided the pro rata method does not produce a material misstatement of income apportioned to Massachusetts (see below)

- Under the pro rata method, the income and apportionment of the member (as adjusted to reflect the determination of income under MA law) is assigned to the respective portion of the combined group's taxable year based on the ratio of months in common with the combined group's tax year
  - if the combined group's taxable year ends December 31, 2010, a member whose income year ends March 31 will include 3/12ths of its adjusted income and apportionment for its taxable year ended March 31, 2010 in the December 31, 2010 combined group taxable year. The member will also include 9/12ths of its adjusted income and apportionment for its taxable year ending March 31, 2011 in the December 31, 2010 combined group taxable year
  - However, as in the interim closing method, for the property factor the average property owned is required to be determined using monthly averaging (see 830 CMR 63.38.1(7)(e)3)
  - The income and apportionment from the fiscalized member's recomputed taxable years is then combined with the income and apportionment of the combined group taxable year (along with the income and apportionment of other members of the combined group for the same period similarly recomputed if necessary)
  - The combined group's taxable income is then apportioned to each of the taxable members of the combined group
- ✓ Estimation of MA-apportioned Income - If the pro rata method requires determining income and apportionment of a corporation whose taxable year has not yet closed, and the information cannot be obtained in time for the other members to file an accurate combined report, the income and apportionment for that unclosed period must be estimated based on available information
- Material Misstatement of MA-apportioned Income - if the use of actual income and apportionment would result in a material misstatement of income apportioned to MA by the combined group, the taxable members must file an amended return reflecting the change from the use of estimated income and apportionment
  - Presumption of Material Misstatement – under the combined reporting regulation it is presumed there is a material misstatement:

- where the aggregate tax liability of the combined group members that filed returns based on a pro rata estimate is found to have understated the aggregate correct tax liability for such members by the greater of \$10,000 or 10% or
  - where the change in the apportioned group income for any one taxable member of the group increases or decreases by more than \$100,000
- ✓ Note: if the auditor determines that there was a material misstatement of MA-apportioned income, and the taxpayer has not filed the requisite amended return reflecting the actual income, the auditor must make the necessary audit adjustments reflecting the actual aggregate tax liability
- ✓ Verify that Same Calculation Method was Used for Income and Apportionment - a “fiscalized” member’s income and apportionment calculation must use the same method unless otherwise permitted (or required) by the commissioner (the commissioner reserves the right to require use of the interim closing method in certain instances)
- ✓ Verify Adjustments Where One Method Used in Preceding Year and Different Method Used in Current Year - a “fiscalized” member’s income and apportionment must be adjusted to prevent income and apportionment from being omitted or duplicated when one method was used in the preceding taxable year and another method was used in the current taxable year
- ✓ Verify Attribution of Combined Group Income from Combined Group’s Tax Year to Member’s Tax Years - after determining the combined group's MA-apportioned taxable income of a “fiscalized” member, that income must be proportionately assigned to the applicable portion of that member's taxable year based on the number of months falling within the common taxable period of the combined group
- ✓ Verify Determination and Sharing of Credits Among Members with Different Fiscal Years - where combined group members are eligible to share credits under 830 CMR 63.32B.2(9), and the members have different tax years, no credit may be shared until the member generating the credit has filed its return for the tax year from which the credit derives
  - Where unitary business members are required to determine credits on an aggregated basis (e.g., as in the case of the research credit (M.G.L. c. 63, § 38M)), those credits are determined for the combined group’s taxable year. Such credits may be claimed by a taxable member on its first return filed for a period on or

after the close of the combined group's taxable year (subject to any statutory restrictions generally applicable with respect to the credit)

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#### **10.12.4 Partial Taxable Years ([830 CMR 63.32B.2 \(12\)\(d\)](#))**

##### **Mid-year Entry or Departure**

Where a member enters the combined group after the start of the combined group's taxable year, only the income, apportionment data, and other tax attributes of the group member after it qualifies for inclusion are used to calculate and apportion the combined group's taxable income.

Where a member leaves the combined group after the start of the combined group's taxable year, through a change of control or otherwise, only its tax attributes before it ceases to qualify for inclusion are used to calculate and apportion the combined group's taxable income.

##### **Value of Member's Owned or Rented Property in Partial Year**

Whenever the income, apportionment data, and other tax attributes of one or more members of the combined group are includible for only part of the taxable year for which the combined group's taxable income is being determined and apportioned, the value of the member's owned or rented property will be reduced to reflect the ratio of the number of months for which the member's tax attributes are included in the combined group's taxable income determination and the total number of months in the combined group's taxable year.

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## **10.13 Combined Reporting Regulation - No Limitation on Other Authority**

There is nothing in the combined reporting regulation that limits or negates the commissioner's authority to make audit adjustments that are otherwise allowed or required under Massachusetts law. [830 CMR 63.32B.2\(13\)](#). In all cases, auditors must be mindful of this when verifying the validity and legality of transactions involving combined group members, including transactions among the group and with other related and unrelated parties.

##### **Applicability of Other Authority**

M.G.L. c. 63, § 39A and M.G.L. c. 62C, § 3A - in general, the provisions of M.G.L. c. 63, § 39A (Business Subsidiary Corporations) and M.G.L. c. 62C, § 3A (Sham Transactions and Related Doctrines) will apply with respect to transactions governed by the combined reporting regulation M.G.L. c. 63, §§ 31I, 31J and 31K - the provisions of M.G.L. c. 63, §§ 31I, 31J and 31K (the "add-back provisions") do not apply to transactions between corporations that are members of the same combined group to the extent such transactions are deferred or eliminated under the combined reporting regulation.

### **Water's Edge Filing (No Affiliated Group Election)**

Note: If an affiliated group election has not been made (i.e., the default Water's Edge rules apply or there is a Worldwide election), the add-back provisions will apply as to the following transactions:

- (1) transactions between a corporation that is a member of the combined group and a corporation that is not a member of the combined group (e.g., certain insurance companies, a security corporation, or certain non-U.S. corporations in the instance where a worldwide election has not been made);
- (2) transactions between corporations that, although under common ownership, are each a member of a separate combined group; or
- (3) transactions between corporations that are otherwise filing on a combined basis when the transaction does not relate to the unitary business

See [10.1.3 Effect of Combined Reporting on Other Legal Authority](#).

## 10.14 Combined Reporting Regulation - Effective Date; Changes and Amendments

### Effective Date

The combined reporting regulation is effective as of and applies to taxable years beginning on or after January 1, 2009. See [830 CMR 63.32B.2\(14\)](#).

### Changes and Amendments

This procedural manual is in no way exhaustive in setting forth the auditor's tools and resources for auditing a Massachusetts combined report. However, it is a good foundational point of reference and should be consistently utilized by the auditor in that manner.

Auditors should keep track of changes and amendments to the combined reporting regulation, including the Department's various public written statements that further explain and detail the effect and implementation of the Massachusetts combined reporting law. The Rulings and Regulations Bureau maintains an email notification service that informs taxpayers, practitioners and the general public regarding updates, changes and amendments to Massachusetts tax laws, including the Massachusetts corporate excise, and this is a good resource to keep up on current proposed and finalized changes and amendments. The following link is a useful auditor resource for tracking changes and amendments to and explanations of the combined reporting regulation, court cases and administrative decisions and other related laws and provisions:

The Department of Revenue's Online Legal Library

<http://www.mass.gov/dor/businesses/help-and-resources/legal-library/>

# Chapter 11

## Withholding Tax Procedures

### Introduction

The withholding of state income taxes by employers is the single most important revenue source for the Commonwealth. As with all other tax audits, a withholding tax audit is to ensure that the proper amount of tax has been reported, and that the taxpayer is in full compliance with all of the reporting requirements in accordance M.G.L. Chapter 62B.

### Administrative Details

#### Identifying Responsible Person(s)

In order to facilitate the collection of tax liabilities imposed on corporations and partnerships by MGL chapters 62B, 64G, 64H and 64I, auditors must identify the responsible person(s) who are liable for such trustee taxes pursuant to M.G.L. chapter 62C, section 31A and Regulation 830 CMR 62C.31A.1.

The identification of responsible persons must be done for all trustee tax audits. Auditors must document in the audit narrative and Audit WorkBench (AWB)-Case Log the names of the individual(s) responsible for paying over the trustee taxes. This information must also be entered into the MASSTAX system under the taxpayer "NOTE" screen.

#### Bank Account Information

During the course of the examination, the auditor must gather the following information relating to the taxpayer's banking activity:

- Name of bank(s) in which the taxpayer has account(s); and
- Account(s) numbers.

If the taxpayer has more than three (3) accounts, the auditor must get the above information for the taxpayer's three primary accounts. The information must be noted in the audit narrative and documented in the MASSTAX system under the taxpayer "NOTE" screen (See Records Review & Verification Procedures).

#### Bankruptcy Information

When a taxpayer files the bankruptcy case, the automatic stay prohibits all of the taxpayer's creditors, including the Department of Revenue, from taking any action to collect any debts or liabilities that relate to the time period before the Petition Date. During the course of the initial taxpayer contact, the auditor should ask the taxpayer if they are in bankruptcy. If the taxpayer is in bankruptcy, the auditor must obtain the following information and forward it to the Litigation Bureau's Bankruptcy Unit immediately:

- The location of the Bankruptcy Court;
- The Bankruptcy Court docket number (stamped on the bankruptcy petition); and
- The petition date (the date the bankruptcy case was filed).

The information must be noted in the audit narrative and Audit WorkBench (AWB)-Case Log to ensure the necessary steps are taken to contact the Bankruptcy Unit in a timely fashion.

**Note: Bankruptcy procedures are discussed in detail within Chapter 6-Specialized Audit Procedures of the Field Audit Procedures Manual.**

### **Case Plan**

The Audit WorkBench-Case Plan will be used to guide the progression of each case. The case plan is structured to allow for flexibility of workflow and is broken into primary tasks and subtasks. When all of the subtasks are completed in a certain primary task, it will automatically be entered in the Audit WorkBench (AWB)-Case Log.

### **Withholding Tax**

#### **Overview**

Withholding refers to income tax withheld from wages by employers to pay employees' personal income taxes. An employer is required by law to withhold Massachusetts personal income tax from wages of residents for services performed either within or outside Massachusetts, and from wages of nonresidents for services performed in Massachusetts.

An **employer** is any person, corporation or organization for which an individual performs a service as an employee. An employer may be an individual, corporation, partnership, estate, trust, association, joint venture or other incorporated organization. Religious, educational, charitable and social organizations also may be employers. Employers are responsible for collecting and remitting employee withholding to the Commonwealth.

All employers with 11 or more full-time equivalent employees are required to offer, as part of the Health Reform signed into law on April 12, 2006, a Section 125 Plan that meets Health Connector regulations. The Commonwealth HealthCare Insurance

Program is run by the Health Connector which connects eligible Massachusetts residents with approved health plans and helps them pay for them. Section 125 Plans let employees save money through pre-tax payments for health coverage. Massachusetts adults must show that they have enrolled in a health insurance plan or lose their personal income tax deduction on their 2007 state taxes.

An **employee** is anyone who performs services for another person or organization under the direction and control of that person or organization. The relationship of employer and employee exists when the person for whom services are performed has the right to control and direct the details and manner in which the job is to be accomplished.

In accordance with MGL, Chapter 62B, the status of workers as employees or independent contractors for wage withholding purposes is governed by Section 3401 of the Internal Revenue Code (IRC). The Commissioner will accept determinations of employee or independent contractor status based on the Internal Revenue Service for purposes of identifying income tax withholding obligations under Chapter 62B (See Technical Information Release 05-11).

The classification of individuals in the workplace is an important issue with many challenges facing the Commonwealth. Entities that misclassify individuals take away tax revenue from the Commonwealth that the state would otherwise receive from payroll taxes. Misclassified individuals do not access to employer provided healthcare coverage and may be paid reduced wages or cash as wage payments.

Businesses that follow all of the relevant statutes regarding employment are at a disadvantage when bidding for the same work, customers or contracts as those businesses that do not follow the same rules. Misclassification significantly reduces fair competition and negatively impacts the business environment in the Commonwealth and results in subsidizing those businesses that do not follow the Law, in essence, businesses that follow the Law and pay the proper taxes and insurance do so having a distinct competitive disadvantage.

As a general rule, the owner of a sole proprietorship is not considered an employee for withholding purposes even if he or she has no other employees. Accordingly, the owner would not register for withholding solely to pay his or her own taxes.

If an owner expects to owe more than \$400.00 in Massachusetts income tax on the income received from the business, he or she is required to make individual estimated income tax payments.

Information on individual estimated income tax payments can be found on the Web Services for Income section of our website at [www.mass.gov/dor](http://www.mass.gov/dor), or DOR's Estimated Income Tax Payment Voucher (Form 1- ES) instructions.

An employer's responsibilities under the withholding tax are listed below:

- Registering with the Department to collect withholding taxes;
- Withholding state income taxes from employees who reside or are employed in Massachusetts and remitting those taxes, along with the appropriate form on time.
- Obtaining from each employee a completed Employee's Withholding Allowance Certificate (Form W-4) and Massachusetts Employee's Withholding Exemption Certificate (Form M-4) included on the form is the employee's full name, home address, Social Security number, the total number of exemptions, and any additional withholding amounts the employee requests to have withheld;
- Submitting to the Department a completed copy of the Form W-4 from all newly hired personnel, or personnel returning to the payroll after 30 days or more off the payroll and independent contractors who will be earning \$600 or more, within 14 days of hire or reinstatement. Reports may be made via DOR's Online New Hire Reporting System, available on the DOR website at [www.mass.gov/dor](http://www.mass.gov/dor).

This information is matched to DOR's database of individuals required to pay child support. When a newly hired employee or independent contractor has a child support obligation, DOR notifies the employer to withhold child support and remit the funds to DOR for distribution to families entitled to support. Employers must remit these funds within three business days of the payroll date.

The information also is used to combat fraud in programs run by various state and federal agencies by:

- Providing each employee with a Wage and Tax Statement (Form W-2) by January 31, or within 30 days if employment terminates before the close of the calendar year, showing the total amount of wages paid, the total Social Security and Medicare taxes withheld, and the amount of Massachusetts income tax withheld for the prior year.
- Contacting the Massachusetts Division of Unemployment Assistance to fulfill the obligations for state employment security taxes.
- Contacting the Internal Revenue Service (IRS) to fulfill obligations for withholding federal income taxes as well as Social Security and Medicare taxes.
- Providing DOR with Form W-2 on magnetic media if you have 250 or more employees as required by the Internal Revenue Service (IRS). This must be filed with the Department by the last day of February for the preceding year. Employers can use the WebFile for Business "Report Wages/File Upload" option to report W-2 filed, instead of mailing the magnetic tapes, cartridges or diskettes to DOR.
- Filing quarterly reports of wages paid to each employee who resides or is employed in Massachusetts. This filing is done online through DOR's WebFile for Business program, or on Employer's Quarterly Report of Wages Paid (Form WR- 1). The information may be recorded on magnetic tape, diskette or cartridge. Employers with 50 or more employees must submit wage reports electronically (See Technical Information Release 04-30). The purpose of the wage reporting system is to verify eligibility for programs such as Welfare, Medicaid,

unemployment compensation and workers' compensation. In addition, it is used to help track down parents who fail to pay the child support they owe. Requirements under this system are separate from requirements to submit income tax withholding forms.

An employer is required to withhold taxes on wages paid to a nonresident for services performed in Massachusetts. However, if a nonresident does not work in Massachusetts, withholding is not required even if they are paid from a Massachusetts office.

A non-Massachusetts employer must deduct and withhold from wages the amount determined for Massachusetts income tax purposes, less any amount deducted and withheld for the employer's state. If there is no state withholding in the home state of the business, the employer withholds and remits the full amount determined for Massachusetts.

A non-Massachusetts employer is not required to withhold if the only Massachusetts connection is the employment, outside Massachusetts, of a Massachusetts resident. The employer may withhold for the convenience of the employee if both employer and employee agree. The employee will owe Massachusetts income tax if the employer does not withhold state income taxes.

Generally, since the Department follows the Internal Revenue Service guidelines for persons subject to withholding, if there is no requirement to withhold federal income tax, because of type of income, there is no requirement to withhold Massachusetts income tax. In particular, withholding by household (domestic) employers is not required. However, domestic employers still are required to withhold Social Security tax from household employees.

Tax-exempt organizations such as religious and government organizations are required to withhold income tax from employees.

### **Withholding Tax on Performers and Performing Entities**

Performers and Performing Entities are individuals or groups of individuals who earn income connected with Massachusetts for performances, whether those performances are of an athletic, entertainment or educational nature, may be subject to withholding on that income. The performing entity's legal classification does not affect the withholding requirement whether it's a corporation, partnership, limited partnership, or any other legal entity.

The performer withholding agent is determined based on the following: the venue where the performance takes place, if the venue or its lessee is/is not a party to contract with the performer or the performing entity, if the promoter is/is not party to the contract, or the withholder may be a vendor or a payroll service. The DOR will assist taxpayers in

determining the performer withholding agent if those in a position to withhold clarification as to their withholding responsibility.

Performers and performing entities are not required to have withholdings if the gross payment for one performance per calendar year by one payer does not exceed \$5,000.00 (See DOR Directive 05-4).

Performers and performing entities requesting and receiving a waiver of withholding are granted under the following circumstances:

- Performer is a resident of Massachusetts and has paid all of his/her Massachusetts taxes to date;
- Performer is treated as an employee of the withholding agent or performing entity for federal income tax withholding purposes;
- Performing entity maintain an office in MA and does not have any outstanding MA tax obligations;
- Performing entity is registered with DOR for Withholding taxes as an employer; or
- Performer or performing entity anticipates that there will not be sufficient income to subject then affected performer(s) to personal income tax in Massachusetts, not more than \$8,000.00 including sources from inside and outside of Massachusetts.

In accordance with the Internal Revenue Code (IRC), federally tax-exempt 501(c)(3), entities are required to withhold if the gross payments to all performers or performing entities that are subject to withholding under the performer withholding regulation, excluding payments for which withholding had been waived, exceed \$10,000.00 for a particular performance, event, program or series. If the gross payments made by the 501(c)(3) entity to a performer or performing entity for performances during one calendar year does not exceed \$5,000.00, then withholding is not required.

### **Performer Withholding Agent**

In order to comply with its obligation as a withholding agent, performer withholding agents must:

- Register using DOR's WebFile for Business(WFB) website, under Performer Withholding;
- Report and pay the amount of taxes withheld during a quarter-monthly period which is defines as the first seven days of a calendar month, the eighth through the 15th day of a calendar month, the 16th through the 22nd of a calendar month, or the 23rd through the last day of a calendar month;
- Reconcile all amounts withheld during the calendar quarter and file a quarterly return before the last day of the month following the close of the calendar quarter, even if the withholding agent has no withholding for the quarter;

- Issue federal Forms 1099-MISC and Form 1042-S (for foreign, non-U.S. person) to any performer or performing entity to whom the withholding agent makes a payment;
- File federal Form 1099-MISC with DOR on or before June 1st of each year if it has made a payment of Massachusetts source income to a nonresident individual in accordance with nonresident personal income tax regulation; and
- Maintain records including the name and social security number of the performer or performing entity, the gross amount paid to the performer or performing entity, the amount of Massachusetts income tax withheld, and the dates and locations of all performances.

### **Performing Entity**

The performing entity must maintain records of the withheld tax through the following:

- Allocate the tax among its member by completing Form PWH-WA, Withholding Allocation Form;
- Supply the form to each of the performing entity's members or participants. All taxes withheld must equal the sum of the allocated taxes to all of the participants of the performing entity;
- Retain copies of notices where DOR permission for reduced or waived withholding has been granted; and
- File and pay Massachusetts corporate excise tax if the performing entity is a corporation.

### **Performer**

An individual performer can claim the withheld amounts as credits towards his/her tax obligation of his/her Massachusetts personal income tax return (Form 1 or Form 1- NR/PY).

The performer must do the following in order to take the appropriate credit:

- Attach a statement of the amount withheld to his/her Massachusetts personal income tax return;
- Supply Form 1099-MISC or Form 1042-S if the performer was paid as an individual by the Massachusetts performer withholding agent; or
- Supply Form PWH-WA if the performer was part of a performing entity.

### **Taxable Wages and Filing Requirements**

Taxable wages include all compensation to an employee for services performed. Payments subject to Massachusetts withholding include wages, salaries, tips, commissions, bonuses, fees or any other item of value paid to an individual for services performed as an employee. It is also important to note:

- Payments of pension, annuity and other similar payments made to Massachusetts residents who have not elected to be exempt from U.S. income tax withholding are subject to Massachusetts income tax withholding.
- Lump sum and eligible rollovers that are subject to federal withholding are also subject to Massachusetts withholding, unless such distributions are of a type that would never be subject to Massachusetts income taxation (See Technical Information Release 02-18 and Technical Information Release 93-3).

The amount of income tax withheld is based on the employee's taxable wages and the number of exemptions claimed, and any additional withholding amounts requested on the Massachusetts Employee's Withholding Exemption Certificate (Form M-4).

Withholding is calculated either by using the tax tables available from the Department or by using a mathematical formula known as the percentage method. These methods, which are explained in Income Tax Withholding Tables Effective January 1, 2012 (Circular M), may be applied on a daily, weekly, biweekly, semi-monthly or monthly basis.

The current tax rate to apply to taxable wages is 5.25%.

The following table puts forth the filing requirements and payment schedules for withholding tax:

<b>Withholding Tax</b>		
<b>Projected annual Withholding tax Collected from all Employees</b>	<b>Return Filing Requirement</b>	<b>Payment Due</b>
\$100 or less*	<b>Annually</b> due by January 31 of the following year.  <b>WebFile for Business or Form M-941A.</b>	Payment due with return. of
\$101 up to \$1,200*	<b>Quarterly</b> due on or before the last day of month following close of calendar quarter, i.e., on or before April 30, July 31, October 31, and January 31.  <b>WebFile for Business or Form M-941.</b>	Payment due with return.
\$1,201 up to \$25,000*	<b>Monthly</b> due on or before 15 <sup>th</sup> day of the following month except for the payments for March, June, September and December-These are due on last day of the following month.	Payment due with return.

## WebFile for Business of Form M-942.

More than  
\$25,000\*

**Quarterly** due on or before last day of  
Month following the close of the  
calendar quarter - i.e., on or before  
April 30, July 31, October 31 and  
January 31.

When Massachusetts income  
tax withheld is \$500 or more  
by the 7<sup>th</sup>, 15<sup>th</sup>, 2<sup>nd</sup> and last  
day of a month, pay over  
Within three business  
days thereafter.

**WebFile for Business.**

\* Employers and businesses with a combined annual withholding, sales/use tax (including sales tax on meals and telecommunications services) and room occupancy excise liabilities of \$10,000 or more are required to file returns and make payments electronically. Once the tax liability reaches the electronic filing threshold in one year, the business must file electronically in all subsequent years, regardless of the amount due, as long as it has an obligation to file one of these three categories of taxes in Massachusetts. Businesses that register on or after September 1, 2003, must file returns and make payments electronically, regardless of the amount of their annual tax liability. Also, all zero tax due returns are required to be filed electronically, regardless of the amount of their tax liability. All payroll service providers (third-party bulk filers) are required to file and pay withholding taxes electronically for all returns.

An electronically filed return or report is deemed timely filed if electronically submitted on or before the due date, before midnight Eastern Time with all required information accurately entered. Upon submission, the filing entity will receive a confirmation number and time-and-date-stamp, which constitute the substantiating date mark providing proof of time and filing date.

In order to be considered timely, a paper return must be received by DOR on or before the due date, or if sent by U.S. mail and delivered after the due date, it must be postmarked by the U.S. Postal Service at least two days prior to the due date.

### Potential Audit Referral Information

The Wage Enforcement Unit (WEU) performs withholding tax audits on businesses and individuals that violate the Commonwealth's personal income tax and employment tax statutes by failing to pay all required payroll and other income tax withholdings to DOR.

In an effort to bring these taxpayers into compliance, taxpayers that fall into the following fact patterns should be referred to WEU or examined as part of an ongoing audit:

- Businesses that are not withholding tax properly (particularly non-registrants).
- Businesses that are paying workers "Under the Table" (restaurants, contractors, landscapers, etc.).

- Out-of-state contractors that are not complying with MA tax laws (particularly withholding, income and corporate).
- Businesses engaged in fraudulent employment activities (not paying workers for services performed).
- Observation that a company under audit has employees but is not registered for WH or appears to be underpaying withholding.
- Businesses that deal in cash and other "off-the-books" schemes to conceal their activities and true tax liability (BODA lifestyle, embezzlement and other wage/illegal activity type cases).
- Businesses that misclassify employees as independent contractors.
- Articles in local newspapers/publications that identify specific companies engaged in fraudulent employment activities.
- Businesses located outside of MA and are not complying with MA withholding laws.
- Businesses that use Western Union (or other services) to transfer excessive amounts outside the country.
- Corporations that list salaries and wages (Form 1120, line 13) or compensation of officers (Form 1120, line 12), but do not file the appropriate withholding with MA.
- Schedule C businesses that list wages (Schedule C, line 25) or cost of labor (Schedule C-1, line 3), but do not file the appropriate withholding with MA.
- Any Voluntary Disclosure WH cases that the Voluntary Disclosure Unit might receive.

In addition, for any BODA, NEAB and Multistate withholding tax case, the proper generic/specific codes in Audit WorkBench (AWB) to properly track the audit.

### **Opening Conference**

The purpose of the opening conference is to obtain any information, which will be necessary to complete the examination. Since the payroll in many businesses is by far the largest operating cost, the preliminary discussions should involve an understanding of the internal controls that the company has in place. The following are suggested questions that should be asked:

- Are employees paid by check?
- Is a payroll bank account maintained?
- Are the activities of time keeping, payroll compilation, payroll check signing, and paycheck distribution performed by separate departments or employees?
- Are all operations involved in the preparation of payrolls subjected to independent verification before the payroll is distributed?
- Are employee time reports approved by supervisors?
- Is the payroll bank account reconciled monthly by an employee having no other payroll duties?

- Who is responsible for preparing withholding tax returns and remitting payments, and are they subject to review?

### **Records Review and Verification Procedures**

Generally the records to be reviewed are as follows:

- Payroll Journal and Recap Sheets
- Federal 940, 941 & related Massachusetts returns & forms (M-941; M-941A; M-3; M-3M; M-3P; WR-1)
- Fringe Benefit Records
- Payroll Check Register
- Income Tax Returns
- Wage Statement (W-2)
- Exemption Certificate (W-4) & related Massachusetts forms (M-4; M-4P)
- Canceled Checks or Electronic Funds Transfer
- Corporate Officer and Bank Account Information

### **Payroll Journal and Recap Sheets**

Three kinds of payroll journals are usually used by employers: hourly, salary and confidential. A confidential payroll may be kept for corporate officers, and an auditor should always check to see if one is maintained. The payroll journal must be checked for accuracy by footing several months of activity. In addition, tracing names and wage or salary rates to records maintained by the personnel department can be useful in verifying the journals accuracy.

Recap sheets are often used in conjunction with the payroll journal as a summation, and are often used in preparing the monthly or quarterly payroll. Recap sheets must also be checked for accuracy by tying them into the payroll journal. Recap sheets will show wages, federal and state taxes and FICA deductions.

### **Federal 940, 941 & Massachusetts M-941; M-941A; M-3; M-3M; M-3P; WR-1**

**Federal 940** is Employees Annual Federal Unemployment Tax Return which reports the total payments as salaries, wages, commissions, taxes, bonuses, vacation allowances, amounts paid to part-time employee, value of goods, lodging, food clothing and non- cash fringe benefits.

**Federal Form 941** is the quarterly return form which combines the reporting of income and FICA taxes withheld from wages, annuities and supplemental unemployment compensation benefits.

The figures on these reports and the payroll journal should be tied in order to determine the accuracy of payroll records.

Reconciliation between Federal and Massachusetts returns should be done on a period by period basis. All differences should be accounted for. If differences occur due to an employee being a nonresident, addresses should first be checked to the Personnel department. It is also important to obtain a job function for all nonresident employees who might perform services both within and without the Commonwealth.

### **Fringe Benefits**

The auditor should look into the fringe benefits, including personal use of a car, personal travel, and meals provided by company. These fringe benefits are part of wages, which are subject to the withholding tax. Fringe benefits might apt to occur for sales personnel and executives, who are required to travel and do promotional type of activities. If an employer provides employees with qualified transportation in a commuter highway vehicle, such as a van or bus, the value of the transportation is not income to the employee.

If there is a discrepancy on withholding tax payments, the auditor must verify by the canceled check. This is the only verifiable proof of payment.

### **Payroll Check Register**

Payroll checks are usually recorded on a payroll register. This record can be used to verify that each employee received a payment of wages after all deductions are made.

### **Income Tax Returns**

Examine income tax returns and ascertain that all amounts being claimed as deductions are being reported as wages subject to withholding. These would include standard line items for salaries and wages; officer's compensation; manufacturing wages included in Cost of Goods Sold; fringe benefits listed in other deductions; and pension and annuities. Once the total claimed a deduction is ascertained, tie them into the payroll and reporting forms.

### **Wage Statement (W-2)**

W-2's issued by the employer are based on the payroll journal. Once again a check should be made to tie these records together. Total tax withheld on W-2's should be tied to the recap sheet. If there are discrepancies that cannot be accounted for, the larger amount of tax due should be used from either the recap sheet or the W-2.

### **Exemption Certificate (W-4)**

All employees must file an exemption certificate with his or her employer showing the number of exemptions to which he or she is entitled. The auditor should always check to

see if the employee has claimed an excessive number of exemptions or an exempt status. An employee is not allowed to claim more than 10 exemptions.

### **Canceled Checks**

If there is a discrepancy on withholding tax payments, the auditor must verify by the canceled check. This is the only verifiable proof of payment.

### **Electronic Funds Transfer**

Electronic filers must also make payments under the Electronic Funds Transfer (EFT) program imposed under G.L. c. 62C, section 85 and 830 CMR 62C.78.1. The regulation permits modification of the EFT program by providing that "any further expansion of the EFT program will be announced in advance by Technical Information Release (TIR) or other Department of Revenue public written statement." 830 CMR 62C.78.1(3)(b)(6).

Any thresholds or procedures established under the EFT regulation that differs from those announced here are hereby modified. While electronic filers must make payments under EFT, filers may be required to make payments under the EFT program without being required to file electronically. A filer that must file and/or pay one type of return or tax by electronic means is not necessarily required to use electronic means for other returns or payments, unless a separate electronic requirement applies.

### **Corporate Officer and Bank Account Information**

The auditor must obtain the name and social security number of the corporate officer who is responsible for the payroll. In the case of an assessment, these corporate officers can be responsible for the withholding tax liability of their employer (See Administrative Details).

## **Chapter 12**

### **Miscellaneous Excise Tax Procedures**

#### **Gasoline Tax Audit Procedures**

##### **Introduction**

Chapter 64A of the General Laws imposes a tax on Gasoline, which is reported on a monthly return Form GT-456. There are three types of license holders: (1) distributor, (2) unclassified importer, and (3) unclassified exporter.

The primary purpose of the gasoline tax audit is to confirm that the taxpayer has reported the correct amount of tax based on net taxable gallons.

##### **Administrative Details**

##### **Identifying Responsible Person(s)**

In order to facilitate the collection of tax liabilities imposed on corporations and partnerships by MGL chapters 62B, 64G, 64H and 64I, auditors must identify the responsible person(s) who are liable for such trustee taxes pursuant to M.G.L. Chapter 62C, section 31A and Regulation 830 CMR 62C.31A.1.

The identification of responsible persons must be done for all trustee tax audits. Auditors must document in the audit narrative and Audit WorkBench (AWB)-Case Log the names of the individual(s) responsible for paying over the trustee taxes. This information must also be entered into the MASSTAX system under the taxpayer "NOTE" screen.

##### **Bank Account Information**

During the course of the examination, the auditor must gather the following information relating to the taxpayer's banking activity:

- Name of bank(s) in which the taxpayer has account(s); and
- Account(s) numbers.

If the taxpayer has more than three (3) accounts, the auditor must get the above information for the taxpayer's three primary accounts. The information must be noted in the audit narrative and documented in the MASSTAX system under the taxpayer "NOTE" screen.

## **Bankruptcy Information**

When a taxpayer files the bankruptcy case, the automatic stay prohibits all of the taxpayer's creditors, including the Department of Revenue, from taking any action to collect any debts or liabilities that relate to the time period before the Petition Date. During the course of the initial taxpayer contact, the auditor should ask the taxpayer if they are in bankruptcy. If the taxpayer is in bankruptcy, the auditor must obtain the following information and forward it to the Litigation Bureau's Bankruptcy Unit immediately:

- The location of the Bankruptcy Court;
- The Bankruptcy Court docket number (stamped on the bankruptcy petition); and
- The petition date (the date the bankruptcy case was filed).

The information must be noted in the audit narrative and Audit WorkBench (AWB) - Case Log to ensure the necessary steps are taken to contact the Bankruptcy Unit in a timely fashion.

**Note: Bankruptcy procedures are discussed in detail within Chapter 6-Specialized Audit Procedures of the Field Audit Procedures Manual.**

## **Reporting Categories**

Reporting categories are broken out as follows on the gasoline tax return:

- Inventories/Receipts;
- Distribution;
- Tax Computation;
- Schedule X-R (Receipts); and
- Schedule X-D (Disbursements).

Audit procedures used in each audit situation will be adapted to the individual taxpayer's system of accounting and record keeping. Since different reporting methods are used by taxpayers to complete gasoline tax returns, it is important that the auditor understand the method utilized by the taxpayer. The auditor should complete an analysis of the accounting system and devise specific audit procedures applicable to the audit. Certain procedures must be performed on each audit (i.e. inventory analysis, distribution verification, receipts reconciliation, etc.).

## **Types of Gasoline Audits Distributor**

The standard approach for auditing a distributor is to verify the accuracy of each line item of the Gasoline Tax Return that is completed by the taxpayer. This involves examining the records for inventory, the receipt of gasoline imported from out-of-state and fuel acquired within the state, as well as verification of tax paid purchases. After completing this phase, the auditor should conduct the distribution check. This covers out-of-state shipments of gasoline

with particular attention given to transporting methods and the status of the purchasers.

This is followed by the check of tax-free sales to other licensed distributors and the United States government and verification of taxable sales including own usage. The remaining audit steps include verification of the figures of the loss and gain adjustment and the credit for tax payments.

### **Unclassified Importer**

While auditing an unclassified importer, the auditor should concentrate on checking the gasoline purchases. The amount of fuel imported into the state is the amount taxed in every instance. The auditor must substantiate that gasoline purchased from within the Commonwealth includes the fuel's excise tax. They must also check that tax free sales, out-of-state deliveries and adjustments for gain or loss of fuel is not used as a reduction to the excise due on the gasoline imported.

### **Unclassified Exporter**

The audit of a holder of a license as an unclassified exporter mandates a plan to check that all of the fuel purchased was exported (Chapter 64A, section 8A states, "A distributor may sell fuel tax-free to any person who is a licensed distributor in another state provided that the entire quantity is to be exported forthwith from this Commonwealth prior to use or resale and provided, further, that such person is licensed by the Commissioner as an unclassified exporter"). The auditor performs this verification by examining copies of the fuels tax returns filed with the state where the gasoline was exported. They also must check delivery documents and transportation charges.

If the unclassified exporter makes sales of gasoline in the Commonwealth, generally the fuel purchased for these transactions is from a source within this state; therefore, the purchase price should include the tax since the gasoline was not exported. Billing statements should be checked to confirm that the excise tax was charged.

### **Analysis of Taxpayer Reporting Method**

During the opening conference, the taxpayer or the taxpayer's representative should explain the reporting method utilized. The auditor should ask open-ended questions to obtain an overview of the entire operation of the business and also identify probable problem areas of tax liability.

Consider the following areas:

- The step-by-step process by which the information is obtained and summarized to prepare the return.
- This information should include the records used to prepare the return.
- General ledger accounts and work papers used to prepare the returns. The auditor should check for related accounts when the Chart of Accounts is reviewed.
- Changes in personnel who prepared the returns. Obtain the name and position of anyone who prepares a specific portion of the return.
- Verification of receipts.
- Tax paid purchases.
- US. Government and Foreign Consulate Sales & other tax-exempt sales such as those to the Port Authority, MWRA, Transit Authorities and the MBTA (see further explanation under "Other Non-Taxable Distributions").
- If the reporting method has been changed, check the different methods used and document the changes on the audit plan.

### **Internal Control Overview**

The taxpayer's system of internal control must be analyzed and evaluated to determine the reliability of the records being examined. The depth of the audit examination is determined in great part by the reliability of the taxpayer's internal control system.

Each system must be analyzed for specific strengths and weaknesses. Some characteristics of good internal controls are listed below:

- A clearly defined separation of responsibility for each function;
- An adequate system of authorization;
- Adequate supervision of duties;
- Adequate documentation;
- Internal audit verification system;
- Segregation of duties;
- Operating Procedures Manual; and
- Independent verification of the prepared financial statements by a Certified Public Accountant firm.

### **Inventory**

Inventory is best examined by verifying each line item of the Inventories/Receipts section of the gasoline tax return.

Generally, verification of inventory includes:

- Determining if the inventory is book or actual;
- Checking meter readings and stick readings for accuracy;

- Spot checking receipt of large quantities of gasoline;
- Checking for inventory in transit;
- Determining product in tanker/barge, or in a dock/inlet facility;
- Determining any product on consignment to others;
- Determining that the last month's closing inventory agrees with the next month's opening inventory;
- Determining whether the closing inventory, at any time, exceeds the taxpayer's storage capacity; and
- Verifying if there is an indication that the closing inventories keep growing over a period of time, which may indicate postponement of tax reporting and payment.

## **Work Papers**

Inventory work papers should include the following information:

- Date of inventory taken and by whom;
- Each location;
- Tank number and capacity;
- Type of fuel stored;
- Pump meter readings, if any;
- Stick readings; and
- Quantity in actual gallons.

If the inventory records are not of the opening dates of the tax return, it is necessary to adjust to that date so that the summary of the total fuel stored agrees with the tax return.

The records for the opening inventory reported for the first day of the audit period and the closing inventory of the last month in the audit must be verified. The actual inventory of fuel on hand, and the pump meter readings, must be taken and recorded in the audit work papers. This is usually done at the initial tour of the facilities.

If the audit uncovers inventory errors and it is necessary for the examiners to take physical inventory, it should be taken in the presence of the taxpayer's principal officer, owner or partner who will be asked to sign a statement that a physical inventory was taken in his/her presence, the date it was taken and the amount of fuel on hand as indicated on the inventory work papers. This is an important part of the audit and it must not be omitted.

The inventory control records of the last date of a test month must be examined in detail to determine if the fuel withdrawn from storage was entered and reported in the sales of that month. Taxable sales are not to be reported by the billing cycle, which method often postpones timely payment of the excise.

## **Purchases**

The purchase of gasoline is reported in the tax return, Form GT-456, as a "receipt". Purchases are classified in different categories and each category's transactions are recorded in Schedules 1 - 5 of the tax return. Purchases may be either on a tax-paid or non-tax paid basis, depending on the license status of the taxpayers, the origin, and destination of the gasoline purchases, the method of transportation used in shipping it and any specific contractual agreements between purchaser and seller.

The examination process includes:

- Checking license status of the purchaser (taxpayer) and the vendors from whom gasoline was purchased;
- Checking the entries in Schedules 1 - 5 with reciprocal reports received from the sellers and from other jurisdictions if purchases were from out-of-state;
- Noting the volume fluctuations of gasoline, seasonal or otherwise; and
- Noting patterns of purchase sources and type of transactions reported during the audit period.
- The verification of purchases requires performing the following:
- Analyzing and evaluating the taxpayers purchasing system for;
  - Control of purchase invoices and related documents;
  - Recording of purchases in the journals, ledgers and accounts; and
  - Payment of the gasoline acquired.
- Checking if all purchases were made by authorized department and approved by responsible person;
- Evaluating the system of internal controls to determine reliability of records;
- Verifying purchase order journal to verify purchases made and reported in the tax return receipt schedules;
- Confirming tax return receipt schedule entries in:
  - Purchase journal;
  - Inventory control records;
  - Transportation charges;
  - Computer printouts for gasoline purchases; and
  - Computer codes for gasoline purchases.

## **Tax Paid Purchases**

If taxpayer reports tax-paid purchases, the auditor confirmation requires:

- Reviewing the returns filed by the vendor selling the gasoline to check whether the transaction was reported as a tax-free sale;
- Examining purchase invoices for an excise charge;
- Tracing the tax-paid purchase accounts payable journal to the ledger account;
- Checking cash disbursement for amount paid on the tax-paid purchase; and

- Verifying account ledgers for possible credit entries which may be offsets for the tax charge. Such credit entries generally are dated several months after the transaction was made.

In the examination of the purchase invoice attention should be directed to examining:

- Delivery ticket associated with the purchase invoice;
- Custom certificates, if imported outside the United States;
- The method of transportation used, i.e. tank wagon sizes usually determine the quantity delivered;
- Storage tank receiving books;
- Inventory control records;
- The amount reported at "net"/60 temp. degree or "actual"/gross gallons;
- Price charged for the product;
  - Note price/gallon and relation between the gallonage and the total amount charges;
  - If tax is included in the price; and
- Note any remarks relating to cash payment or credit and trace to associated book entries.

### **Direct Delivery Shipments**

The auditor must examine sales journals and customer accounts for "direct" delivery shipments of gasoline that may not be in the purchasing records.

Invoices must be reviewed to determine if they contain instructions to deliver the purchased gasoline "direct" to a customer or taxpayer's station(s) and not to own terminal storage tanks. Check all such deliveries to the purchase books and tax return schedules. The auditor must verify that all "direct" delivered purchases are deemed sales which are taxable.

The examination of the following books is required:

- Product control records;
- Purchase contracts;
- Receiving records;
- Exchange agreements;
- Terminal reports;
- Purchase orders;
- Purchase journal, exchange journal;
- Accounts payable, notes payable ledger;
- Voucher register;
- Cash disbursement journals;
- Inter-company journals; and
- Company owned/leased/operated service station books.

## **End of Month Purchases**

The auditor should verify that end of month purchases are not postponed to following month's tax return but are reported in the month title passed.

## **Unreported Purchases**

Audit work papers for unreported purchases should state:

- The date of purchase;
- Name of seller and address;
- Purchaser's name and address;
- Quantity (gallons) gasoline purchased;
- Price per gallon;
- Tax rate/amount, if any, charged;
- Total price;
- Transportation company;
- Place where delivered;
- Purchase invoice number;
- Delivery ticket number if different from purchase invoice;
- Drivers of truck delivery; and
- Signature (name) of receiver (which may be different than purchaser's name).

Unreported purchases or errors uncovered are listed and explanations are requested. Unsatisfactory explanations require summarizing the purchased amount of gasoline and assessing the excise.

## **Total Sales**

Total sales consist of all taxable and non-taxable sales made during the reporting period.

- The reportable sales categories are:
- Sales and transfers out of Massachusetts;
- Sales to export permittees;
- Sales to licensed distributors in Massachusetts;
- Sales to United States Government (only under contract on Form 32 and 33 or authorized purchase orders);
- Other non-taxable distribution;
- Gain or Loss adjustment;
- Net Taxable sales; and
- Taxable gallons consumed or used.

## **Sales and Transfers Out of Massachusetts**

The sales and/or transfer of gasoline outside of the Commonwealth are not taxable. All such transactions are reported on Schedule 6 of the gasoline tax return.

The following must be verified:

- Copies of fuel tax returns filed with other states;
- Delivery tickets;
- Shipping records;
- Delivery point location;
- If customer delivery address differs from billing address;
- The tax rate on out-of-state sales; and
- Schedule 6 entries to taxpayer's books.

## **Sales to Export Permittees**

These sales are reported on Schedule 7 of the gasoline tax return and are not taxable. The

following steps must be performed:

- Review the date of license issuance and renewal;
- Examine purchase order for delivery destination;
- Compare purchase order and delivery ticket destinations;
- Verify that the gasoline scheduled for out-of-state delivery was the quantity actually delivered to that location;
- Check accuracy of Schedule 7 to taxpayer's books;
- Determine if exporter has service station operations in Massachusetts. Gasoline deliveries to a Massachusetts located service station or fuel storage tank are taxable to Massachusetts; and
- Compare Schedule 7 entries to the tax receipts schedule of export permittee.

## **Sales to Licensed Distributors in Massachusetts**

These sales are reported on Schedule 8 of the gasoline tax return and are not taxable. However, if a licensed distributor places gasoline into the tank of a motor vehicle owned/operated by another licensed distributor then the sale is taxable to the distributor making the sales and are not classified as non-taxable reportable in Schedule 8.

The auditor must:

- Verify date of license issuance and renewal;
- Compare Schedule 8 entries of taxpayer to the Schedule 2 entries of the license distributor purchasing the fuel;

- Examine billing invoices as to the quantity of gasoline sold, transferred, or exchanged;
- Check billing invoices for state tax charges; and
- Check date the sale, transfer, or exchange occurred for the correct tax reporting date. Billing date, if any, may not be the same as the date the sale, transfer, or exchanged occurred.

### **Sales to United States government (Bulk)**

These sales are reported on Schedule 9 of the gasoline tax return and are not taxable. However, these sales must be made pursuant to a sales contract executed on United States Forms 32 and 33 or a duly authorized purchase order for gasoline purchased in bulk quantities. The fuel must be invoiced to the United States Government and usually refers to the contract and delivery numbers.

The auditor must:

- Examine contracts with United States Government and check contract dates;
- Check terms of contract for authorized agent signatures, etc.;
- Examine gasoline delivery tickets for address, quantity, and signatures of acquirer;
- Check delivery tickets to billing invoices;
- Match purchase orders to delivery tickets and billing;
- Verify payment was made by United States agency as contract term provides;
- Check sales to contractors working on United States jobs, these are taxable; and
- Ensure that retail sales to United States owned motor vehicles are not included in Schedule 9 but are reported in Schedule 11.

### **United States Government and Foreign Consulate Sales (Retail)**

Sales by the distributor's service station dealers to motor vehicles operated by the United States Government and certain foreign consulates are not taxable and should be reported on Schedule 11.

The following must be verified:

- Sales invoices for date of purchases, purchase name, address, motor vehicle registration, quantity purchased, along with the name and address of dealer;
- Schedule 11 entries to sales invoice for correctness;
- Sales to Consulars must meet provisions outlined by United States Department of State, effective June 1, 1988, and subsequent amendments and procedures outlined in Administrative Procedure 621.3.1;
- Copies of consular tax exemption cards issued by United States State Department for authorized person's name and signature;
- Purchase invoices must be signed only by authorized person;

- Billing of sale must be to the United States agency; and
- Service station dealer reconciliation statements with distributors accounting records for tax credit to dealer for the month the deduction was taken in Schedule 11.

### **Other Non-Taxable Distributions (Return to Reporting Method)**

Such losses are not taxable and should be reported on Schedule 10 of the gasoline tax return.

#### 1. Losses due to theft fire and flood.

The following must be verified:

- Reason reported by the taxpayer for each deduction by reviewing documents relating to the occurrence;
- Police reports for thefts;
- Fire department reports for fire loss;
- Insurance claims;
- Environmental agency reports;
- Fuel control/use records;
- Inventory records;
- Fuel used in equipment;
- Types of company equipment;
- Use records of equipment; and
- Company write-off records including reports to stockholders on major catastrophe cases.

Such sales are not taxable and should be reported on Schedule 10 of the gasoline tax return.

#### 2. Sales to exempt entities are non-taxable.

They include the following:

- Massachusetts Port Authority;
- MWRA;
- MBTA; and
- Transit Authorities.

### **Gain or Loss Adjustment**

Stock loss or gain inherent in storage, transportation and marketing of gasoline is reported on line 15 of the gasoline tax return. This adjustment is restricted to a licensed

distributor. Unclassified importers must pay the excise on the amount imported at the time of importation and not on the sale of gasoline.

The auditor must:

- Prepare schedule of losses and gains;
- Compare losses and gains;
- Note any recurrence of amounts;
- Note seasonal cyclical trends;
- Inquire from taxpayer how gain/loss was determined;
- Analyze gain/loss monthly amounts to ensure that loss amounts less than .005 of gasoline in storage is reasonable. Excess quantity should be questioned; and
- Check purchases for missing unreported receipt of fuel if a large gain is shown.

### **Net Taxable Sales**

The term net taxable sales describes the transactions upon which the excise is imposed. Usually it is that amount of gasoline remaining after the non-taxable categories of distribution as detailed in Schedule 6 - 10 and labeled total non-taxable distribution and "deducted from the amount of total gallons" reported in line 9 of the gasoline tax return.

Taxable sales are verified by the examination which includes:

- Reviewing the Chart of Accounts for revenue and sales accounts;
- Reviewing taxpayer's method of reporting gasoline transactions;
- Reconciling recorded and reported amounts in the books;
- Determining taxable customer accounts;
- Determining how sales are recorded;
- Reviewing billing methods;
- Testing all sales invoices to verify computer codes for accuracy;
- Tracing sales invoices to customer ledger accounts;
- Analyzing all billing invoices in terms of gallons of gasoline;
- Tracing delivery tickets information (gallons/price) to billing amounts and sales journals;
- Comparing daily recaps documents to daily sales reported and accumulated;
- Checking correct tax billing for rate and amount charged accuracy if taxpayer uses tax accrual reporting method;
- Reconciling tax accruals to the amount reported in the tax return;
- Examining general accounts and journals for unusual sales entries;
- Analyzing transfer of gasoline amounts between distributors classified as exchange accounts;
- Requesting audit results/adjustments by other jurisdictions including the IRS where applicable;

- Examining customer purchase orders and tracing to the delivery tickets, sales invoices, customer ledger cards, accounts receivable and customer payment; and
- Obtain explanation for credits issued; check for any credit arising with tax-free delivery of gasoline product.

Sales to unclassified importers from gasoline stored within the Commonwealth are taxable and reported by the distributor; sales from out-of-state, delivered by the taxpayer are taxable and reported by taxpayer; sales by taxpayer from out-of-state, terminal, picked up by the unclassified importer, where title to the gasoline has passed to the importer, is reported by the importer and not by the taxpayer.

### **Taxable Gallons Consumed or Used**

If the taxpayer transfers gasoline into a storage tank for fueling his own or other motor vehicle, that amount so stored is a taxable transaction and reported on line 18 of the gasoline tax return.

The following must be verified:

- Inventory control records for particular storage tank from which gasoline is pumped into motor vehicle tanks;
- Pump daily sheet;
- Meter readings;
- Motor vehicle use records, including odometer readings for accountability of fuel use;
- Fuel sales to motor vehicles owned/operated by others;
- Contractor's accounts for credit entries for fuel sold to contractor as an offset to contractual charges;
- Losses missing from a storage location used to fuel motor vehicles is not allowed; and
- Service station operations for losses which are not allowed on the gasoline tax return but may be refundable by application for refund by the taxpayer.

### **Aviation Gasoline**

Aviation Fuel is included in M.G.L. Chapter 64A, but has a variable tax rate which is updated quarterly by the Excise Unit. The tax rate can be found on the DOR Website which lists the current quarterly rate as well as the historical rates.

All sales of aviation gasoline must be recorded on Form AF-1. Gasoline

Distributors can sell aviation gasoline tax-free as follows:

- Sales to other licensed distributors;

- Sales to licensed exporters provided the whole quantity is shipped outside of Massachusetts;
- Aviation gasoline exported outside of the Commonwealth by a company; and
- Sales to the United States Government and other exempt entities.

Unclassified Importers cannot purchase aviation gasoline tax-free within Massachusetts.

If you are importing aviation gasoline from another state or foreign country, you must file Form AF-1.

If you are a Gasoline Exporter, you can purchase aviation gasoline tax-free in the Commonwealth provided the entire quantity is shipped outside of Massachusetts.

### **Special Fuels Tax Audit Procedures (Supplier) Introduction**

Chapter 64E of the General Laws imposes a tax on Special Fuels used in the propulsion of Motor Vehicles. A supplier of special fuels, the licensee, files a monthly return (Form SFT-3) accounting for the purchase and disposition of that fuel.

The correctness of the tax return filed by the taxpayer is verified by the auditor whose objective it is to ascertain the proper amount of tax due.

### **Administrative Details**

#### **Identifying Responsible Person(s)**

In order to facilitate the collection of tax liabilities imposed on corporations and partnerships by MGL chapters 62B, 64G, 64H and 64I, auditors must identify the responsible person(s) who are liable for such trustee taxes pursuant to M.G.L. chapter 62C, section 31A and Regulation 830 CMR 62C.31A.1.

The identification of responsible persons must be done for all trustee tax audits. Auditors must document in the audit narrative and Audit WorkBench (AWB)-Case Log the names of the individual(s) responsible for paying over the trustee taxes. This information must also be entered into the MASSTAX system under the taxpayer "NOTE" screen.

#### **Bank Account Information**

During the course of the examination, the auditor must gather the following information relating to the taxpayer's banking activity:

- Name of bank(s) in which the taxpayer has account(s); and

- Account(s) numbers.

If the taxpayer has more than three (3) accounts, the auditor must get the above information for the taxpayer's three primary accounts. The information must be noted in the audit narrative and documented in the MASSTAX system under the taxpayer "NOTE" screen.

### **Bankruptcy Information**

When a taxpayer files the bankruptcy case, the automatic stay prohibits all of the taxpayer's creditors, including the Department of Revenue, from taking any action to collect any debts or liabilities that relate to the time period before the Petition Date.

During the course of the initial taxpayer contact, the auditor should ask the taxpayer if they are in bankruptcy. If the taxpayer is in bankruptcy, the auditor must obtain the following information and forward it to the Litigation Bureau's Bankruptcy Unit immediately:

- The location of the Bankruptcy Court;
- The Bankruptcy Court docket number (stamped on the bankruptcy petition); and
- The petition date (the date the bankruptcy case was filed).

The information must be noted in the audit narrative and Audit WorkBench (AWB) - Case Log to ensure the necessary steps are taken to contact the Bankruptcy Unit in a timely fashion.

**Note: Bankruptcy procedures are discussed in detail within Chapter 6-Specialized Audit Procedures of the Field Audit Procedures Manual.**

### **Preliminary Research**

Prior to the "field" audit the auditor should perform a review of the following:

- Taxpayer's license application, if available (Form SFT-1);
- Tax returns filed for the period under audit;
- Taxpayer's prior audit history; and
- Review of prior audit if any; request the audit folder from the Records Management Bureau.

### **Field Review**

Upon completion of the above review, the auditor is now ready to perform a field audit. The following documents should be examined to verify the accuracy of the tax returns filed:

- All journals and ledgers which relate to entries made on the tax return;

- Daily fuel control sheets;
- Work papers and schedules used to prepare the tax returns; and
- Any other records which the taxpayer maintains that may be useful in the final audit determination.

## **Reporting Categories**

The supplier's tax return consists of the following categories:

- Inventories and Receipts
- Disposition
- Type of Special Fuel
- Schedule A - Bulk Purchases (Both in-state and out-of-state)
- Schedule B - Taxable Gallons Placed or Used in Own or Leased Registered Motor Vehicles
- Schedule C - Taxable Gallons Sold to Other Users
- Schedule D - Taxable Gallons Sold to User-Sellers, including company's own stations (Bulk Sales)
- Schedule E - Non-Taxable Gallons Sold or Used
- Own use;
- Sales to others (sales to licensed Suppliers, sales of home heating oil, sales for non-registered equipment, etc.); and
- Transfers out-of-state (additional schedule insert - Part C).

## **Inventories and Receipts**

The auditor must verify the accuracy of inventory items as reported in this section. Gallons purchased must agree with amounts reported on Schedule A.

## **Disposition**

Line items in this section must be verified to determine the accuracy of the corresponding schedules.

### **Schedule A**

#### **Bulk Purchases**

Purchases should be verified for accuracy. The auditor must review Purchase Journal and invoices from suppliers as a check against the amounts reported.

### **Schedule B**

Taxable Gallons Placed or Used in Own or Leased Registered Motor Vehicles.

If the taxpayer operates motor vehicles the examination of the records may start with checking the taxpayer's use as reported in Schedule B.

The following should be verified:

- Fueling records;
- Pump readings;
- Driver logs;
- Trip records;
- Mileage records; and
- Odometer readings.

The auditor should take note of all possible internal use of fuel by the taxpayer. This may require obtaining all of the trucking and other activities involving use of motor vehicles, and other equipment. For instance, determine how non-highway, unregistered equipment is transported and where it is working.

### **Schedule C**

Taxable Gallons Sold to Other Users (Fuel Placed in Registered Motor Vehicles Only) All sales reported on Schedule C should be verified as follows:

- Check pump meter readings;
- Review customer billing and accounts receivable;
- Verify cash sales records; and
- Exam sales invoices.

Note infrequent sales or small amounts of fuel sold by the taxpayer which may represent only a partial list of sales to a customer.

### **Schedule D**

Taxable Gallons Sold to User-Sellers (Bulk Sales). Companies that drop into their own stations should also be reported on this schedule.

All sales reported on Schedule D are taxable and proper examination of taxpayer's books should be performed to verify amounts reported.

### **Schedule E**

Non-Taxable Gallons Sold (Sales to licensed Suppliers or sold for use in non-registered equipment or transferred out-of-state or used in the company's own non-registered equipment).

Gallons reported on Schedule E are not taxable. The auditor should complete a thorough review of all gallons listed on this schedule. Some of these gallons may be subject to a sales/use tax.

### **Special Fuels (User-Seller)**

The main purpose of this audit is to verify that all special fuel purchased has been paid to their supplier and that the supplier has in turn remitted such tax to the Commonwealth on their monthly Form SFT-3.

The taxpayer files Form SFT-4, User-Seller's Special Fuels Tax Return, on a monthly basis, reporting the names of its suppliers and accounting for its fuel purchases.

At the outset of the audit, the auditor should check all storage tanks and meter readings. The auditor should then obtain a list of all registered and non-registered equipment.

Next, the auditor should check Accounts Payable in order to ensure that the proper amount of tax was charged by the oil company. This can usually be verified from purchase invoices and accounts payable journals. Since M.G.L. Chapter 64E does not mandate that the Special Fuels tax be stated on the purchase invoice, the auditor may also need to obtain the oil company's Form SFT-3 from the Records Management Bureau in order to verify that the tax was properly remitted to the Commonwealth. The auditor should also verify that all purchases have been made from a licensed supplier.

Accounts Payable and Cash Disbursements should be thoroughly review to determine if any other fuel purchases (diesel, home heating oil, kerosene or propane) were made and used in registered equipment.

### **Liquefied Gases (Propane and Compressed Natural Gas)**

Liquefied gases such as propane and compressed natural gas are reported on a separate insert to the SFT-3 titled Schedule LG. These rates are also variable and are updated each quarter on the DOR Website by the Excise Unit. (Liquefied gas is that type of Special Fuel which is a combustible gas and exists in a gaseous state at a temperature of 60° Fahrenheit and a pressure of 14.7 pounds per square inch absolute).

### **Jet Fuel Tax**

The Jet Fuel (Aircraft Fuel) Tax is a local option tax enacted by a city or town and is imposed by M.G.L. Chapter 64J which is collected (and audited) by the Department of Revenue (DOR). The money is not part of the general fund, but is remitted by DOR directly to the taxing city or town. Suppliers and User- Sellers of Jet Fuel must submit license application Form JFT-1 (no fee) initially and renew by the first of January each year.

All licensed suppliers must file Form JFT-4S and user-sellers of jet fuel must file Form JFT-4-U on or before the 20th day of each month following the month of sales or use. A listing of which municipalities have enacted this local option may be obtained from the Excise Unit. If a new city or town enacts the Jet Fuel tax, the Excise Unit will notify supplier and user-sellers of record.

The Jet Fuel tax is also a variable tax and is updated on a quarterly basis on the DOR Website by the Excise Unit.

### **Underground Storage Tank Program**

Any person who maintains an underground storage tank (10% or more of the tank volume and piping is buried below the ground surface) located in Massachusetts and dispenses petroleum products directly into motor vehicles is responsible for collecting a delivery fee of \$0.0025 per gallon and remitting the same on a monthly basis (UST Form 500) to the Department of Revenue. The delivery fee shall be applicable to deliveries made on or after April 1, 2003 in accordance with Regulation 503 CMR 4.00.

Each owner of an underground storage tank which is used to store petroleum products at a Dispensing Facility must a \$250.00 annual tank fee for the benefit of the fund which is due June 1st of each year. The Underground Storage Tank Petroleum Cleanup Fund was established to assist with cleanup of contaminated areas which fees are regulated by M.G.L. Chapter 21J.

A petroleum product is obtained from distilling and processing crude oil and is capable of being used as fuel for the propulsion of a motor vehicle or aircraft. The term does not include naphtha-type jet fuel, kerosene-type jet fuel, petroleum product destined for use in chemical manufacturing or feedstock of that manufacturing or fuel oil used for heating purposes.

Although the New England Audit Bureau is not responsible for either the filing or auditing of UST Form 500, the returns can be used as a tool to trace motor fuels from the wholesale to the retail level.

### **IFTA Audit Procedures Introduction**

M.G.L. Chapter 64F imposes a tax of fuel and special fuels acquired outside and used within the Commonwealth of Massachusetts. Therefore, a motor carrier is any person who uses or operates a motor vehicle for commercial or business purposes using fuel purchased outside Massachusetts on Massachusetts highways. All such vehicles using Massachusetts highways must have (1) a Motor Carrier License; (2) a Motor Carrier Tax Vehicle License, and (3) if the vehicle is propelled by a "special fuel", a "User of Special Fuel" License (See 830 CMR 64F.6.1).

IFTA is the International Fuel Tax Agreement which is an agreement between the United States and the Canadian Provinces. Each IFTA motor carrier selects a base state or base jurisdiction which collects motor fuel taxes on qualified motor vehicles for its own jurisdiction and other IFTA jurisdictions then distributes the appropriate taxes to these jurisdictions.

Motor carriers licensed under the International Fuel Tax Agreements whose base state is Massachusetts shall file a calendar quarterly report for the previous calendar quarter with the Commissioner. The timely filing of the quarterly returns and payment of taxes due to the Commonwealth for all Member Jurisdictions discharges the responsibility of the licensee for the filing of reports and the payment of individual taxes to all Member Jurisdictions.

## **Administrative Details**

### **Identifying Responsible Person(s)**

In order to facilitate the collection of tax liabilities imposed on corporations and partnerships by MGL chapters 62B, 64G, 64H and 64I, auditors must identify the responsible person(s) who are liable for such trustee taxes pursuant to M.G.L. chapter 62C, section 31A and Regulation 830 CMR 62C.31A.1.

The identification of responsible persons must be done for all trustee tax audits. Auditors must document in the audit narrative and Audit WorkBench (AWB)-Case Log the names of the individual(s) responsible for paying over the trustee taxes. This information must also be entered into the MASSTAX system under the taxpayer "NOTE" screen.

### **Bank Account Information**

During the course of the examination, the auditor must gather the following information relating to the taxpayer's banking activity:

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- Account(s) numbers.

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### **Bankruptcy Information**

When a taxpayer files the bankruptcy case, the automatic stay prohibits all of the taxpayer's creditors, including the Department of Revenue, from taking any action to collect any debts or liabilities that relate to the time period before the Petition Date.

During the course of the initial taxpayer contact, the auditor should ask the taxpayer if they are in bankruptcy. If the taxpayer is in bankruptcy, the auditor must obtain the following information and forward it to the Litigation Bureau's Bankruptcy Unit immediately:

- The location of the Bankruptcy Court;
- The Bankruptcy Court docket number (stamped on the bankruptcy petition); and
- The petition date (the date the bankruptcy case was filed).

The information must be noted in the audit narrative and Audit WorkBench (AWB) - Case Log to ensure the necessary steps are taken to contact the Bankruptcy Unit in a timely fashion.

Note: Bankruptcy procedures are discussed in detail within **Chapter 6-Specialized Audit Procedures** of the Field Audit Procedures Manual.

### **IFTA Requirements**

An IFTA motor carrier is any person who uses or operates an IFTA qualified motor vehicle for commercial or business purposes on Massachusetts highways and the highways of at least one other International Fuels Tax Agreement (IFTA) jurisdiction.

An IFTA qualified motor vehicle is a vehicle other than a recreational vehicle, that is used, designated or maintained for the transportation of persons or property and that (i) has two axles and a gross vehicle weight or registered weight exceeding 26,000 pounds; (ii) has three or more axles on the power unit, regardless of weight; or (iii) is used in combination and the combined gross vehicle weight or registered gross vehicle weight exceeds 26,000 pounds. IFTA motor carriers must register and file returns with their base jurisdiction for activity in all IFTA jurisdictions. All such qualified vehicles using Massachusetts highways must have (1) an IFTA license and (2) two IFTA decals.

The International Fuel Tax Agreement reduces the compliance burden for motor fuel use tax reporting because:

- The motor fuel use tax licenses issued by the base jurisdiction authorizes travel in all member jurisdictions;
- IFTA tax reports submitted to the base jurisdiction detail operations in all IFTA jurisdictions and reflect net tax due or overpayments for all jurisdictions; and
- IFTA audits are, in most cases, performed only by the base jurisdiction.

### **License Applications**

IFTA motor carriers based in Massachusetts must file license application Form IFTA-1 initially and must renew licenses no later than every January 1st. There is a grace period through the end of February if your vehicle still displays the prior year's decals. Owner-operators may use a Social Security Number. All other applicants are required to

use a Federal Identification Number. Two IFTA decals which can be issued only by the DOR through the mail must be affixed to each vehicle.

### **Filing Requirements**

IFTA motor carrier tax licensees are required to file IFTA Quarterly Fuel Use Tax Reports (Form IFTA 100 and 101) by the last of the month following the close of the quarter, even if no tax is due. If a licensee's status has changed and is no longer an IFTA qualified motor carrier, the IFTA license and both IFTA decals must be returned to the DOR with a letter requesting cancellation, indicating the effective date.

### **Tax Rates**

Current tax rates can be found at [www.IFTACH.org](http://www.IFTACH.org). Member jurisdictions provide the tax rate information to IFTA, Inc. IFTA, Inc. was established to assist the Member Jurisdictions in their administration of the International Fuels Tax Agreement (IFTA). Each member jurisdiction is responsible for the information reported to IFTA, Inc. and posted on the web page. Additionally, each Member Jurisdiction is responsible for updating the information reported by them to assure that it remains accurate.

### **Records**

The licensee is required to preserve the records upon which the quarterly tax return or annual tax return is based for four years from the tax return due date or filing date, whichever is later, plus any time period included as a result of Form A-37 (waivers) or jeopardy assessments.

Failure to provide records requested will extend the four year record retention requirement until the records are presented for audit purposes.

Failure to comply with maintaining records as required may show cause for revocation of the license. The base jurisdiction has the authority to defer license revocations if the licensee demonstrates evidence of compliance for future operations.

### **Exemptions (Massachusetts Turnpike)**

Fuel used on any turnpike constructed by the Massachusetts Turnpike Authority is exempt. For travel on the Massachusetts Turnpike on or after April 1, 1998, IFTA licensees may take the Massachusetts Turnpike exemption for IFTA qualified vehicles only on the IFTA consolidated return. Turnpike miles are to be included in total IFTA miles (Column H of IFTA-101) and excluded from taxable miles on the IFTA return (Column I of IFTA-101) for travel in Massachusetts. IFTA carriers may not make separate applications for Turnpike refunds using the Massachusetts Department of Revenue's Special Fuel and/or Gasoline Refund Application for IFTA qualified vehicles travel occurring on or after April 1, 1998.

Motor fuel for which the Turnpike exemption is taken is subject to the 6.25% Use Tax imposed by M.G.L. Chapter 64I, section 2. Registrants are required to file an annual Massachusetts Business Use Tax Return (ST-10) and remit the 6.25% Use Tax on the cost of the fuel for which the exemption was taken. The return is due with payment on or before April 15th, for purchases made in the prior calendar year.

### **IFTA Governing Documents**

The provisions of the three IFTA documents are equally binding upon the Member Jurisdictions and IFTA licensees. The three (3) IFTA governing documents are:

- The IFTA Articles of Agreement;
- The IFTA Audit Procedures; and
- The IFTA Procedures Manual.

The IFTA Articles of Agreement, the IFTA Audit Procedures and the IFTA Procedures Manual can be found at [www.IFTACH.org](http://www.IFTACH.org).